PART I: INTRODUCTION **1**

A. ARISTOTLE'S CONCEPT OF DISTRIBUTIVE JUSTICE 2
B. BASIC PRINCIPLES OF DISCRIMINATION 3
I. Elements of the discrimination-analysis *3*
II. Proposal for an analytical framework *8*
III. A brief note on ability to pay *13*
C. OVERVIEW OF THE STUDY 15

PART II: ARTICLE 24 OF THE OECD MODEL CONVENTION **20**

1. ORIGIN OF ARTICLE 24 OECD MC 20
A. Historical roots of the provision *20*
B. The League of Nations *24*
C. The OEEC Fiscal Committee *25*
I. The first report of Working Party no. 4 25
II. Reception of the first report 29
III. The second report 31
IV. The third report 31
V. The final report 32
VI. Conclusions 34
D. The genesis of the OECD MC *35*
2. THE CURRENT VERSION OF ARTICLE 24 OECD MC 38
A. General remarks *38*
B. Article 24(1): nationality non-discrimination *42*
I. General 42
II. No taxation without discrimination? 43
III. Nationality 44
III.A. Individuals 45
III.B. Other persons 45
a. General 45
b. The nationality of legal entities 47
1. General 47
2. Case law 53
a. Transvaal Special Income Tax Court 10 March 1992 53
b. Court of Appeal 's-Hertogenbosch 13 December 2002 54
IV. Entitlement to Art. 24 55
V. The comparability test: 'in the same circumstances' 56
V.A. On sameness and similarity 56
V.B. Case law 63
a. Leeuwarden Court of Appeal 7 April 2000 63
b. United Dominions Trust Ltd 63
c. Belgian Supreme Court 30 June 1988 65
d. The Anglo-Swiss Land and Building Company Ltd. 67
e. Biso 74
f. Saipem 78
V.C. Discrimination 'on the basis of' nationality? 80
VI. The disadvantage test: 'other or more burdensome' 83
VI.A. General 83
VI.B. Reverse discrimination 87
VI.C. Other issues 91
VI.D. Case law 92
a. Woodend Rubber and Tea 92
b. Dutch Supreme Court 14 June 1972 94
c. Bundesfinanzhof 14 March 1989 101
d. Conseil d'Etat 28 May 1986 103
VII. Reciprocity 104
VII.A. General 104
VII.B. Case law 106
a. American Trust Company 106
b. Brown & Williamson Ltd 108
c. Dutch Supreme Court 2 September 1992 109
d. Dutch Supreme Court 20 November 2009 111
VII.C. Conclusion 112
VIII. Comparability as a safety valve? 116
IX. Other or more burdensome as a safety valve? 120

C. Article 24(2): stateless persons ... *122*
I. The 1954 Convention relating to the Status of Stateless Persons ... 122
II. The OECD MC ... 123
D. Article 24(3): permanent establishments ... *126*
I. Entitlement to Article 24(3): what is 'an enterprise'? ... 129
II. The comparability test: 'an enterprise carrying on the same activities' ... 131
II.A. General ... 131
a. 'Carrying on the same activities' ... 132
b. Separate entity approach ... 133
II.B. Case law ... 135
a. Case law on the subject of comparison ... 135
1. Reuters Ltd ... 135
2. Brussels Court of Appeal 28 May 1993 ... 140
3. Ghent Court of Appeal 17 November 1994 ... 143
4. Bundesfinanzhof 22 April 1998 ... 144
5. Bundesfinanzhof 10 March 2005 ... 145
6. Verwaltungsgerichtshof 16 February 2006 and 28 November 2007 ... 147
b. Case law on the object of comparison ... 151
1. Swiss Bundesgericht 28 November 2005 ... 151
2. Finanzgericht Köln 20 September 1995 ... 152
3. UBS AG ... 153
III. The disadvantage test: 'taxation … less favourably levied' ... 156
III.A. 'Taxation' ... 156
III.B. 'Less Favourably levied' ... 159
a. Assessment of tax ... 162
b. Structure and rate of tax ... 164
1. Progressive scales and the non-resident's worldwide profits ... 164
2. Tax-free thresholds ... 168
3. Special taxes on a non-resident's PE ... 169
c. Dividends received in respect of holdings owned by a PE ... 173
d. Withholding tax on dividends, interest and royalties received by a PE ... 176
e. Credit for foreign tax and the extension to PEs of the benefit of tax treaties concluded with third States 177
III.C. Case law ... 181
a. Assessment of tax ... 181
1. Brussels Court of Appeal 30 June 1994 ... 181
2. Commerzbank AG v IRC ... 182
3. Automated Securities Clearance ... 185
4. Saipem ... 189
b. Structure and rate of tax ... 191
c. Dividends received in respect of holdings owned by a PE ... 192
1. UBS AG ... 192
d. Credit for foreign tax and the extension to PEs of the benefit of tax treaties concluded with third States 202
1. Finanzgericht Hamburg 9 August 1985 ... 202
2. Dutch Supreme Court 8 February 2002 ... 206
e. Disadvantages caused by the treaty of which Art. 24(3) is invoked ... 212
1. Metchem Canada Inc ... 212
2. Brussels Court of First Instance 9 November 2006 ... 214
III.D. No extension to personal allowances ... 218
a. Dutch Supreme Court 19 December 1990 ... 220
b. Dutch Supreme Court 11 September 1991 ... 221
c. Dutch Supreme Court 6 November 1996 ... 222
d. Antwerp Court of Appeal 2 February 2010 ... 224
e. Conclusion ... 227
E. Article 24(4): deductibility ... *229*
I. General ... 229
II. The comparability-test ... 231
III. The disadvantage test ... 238
IV. Domestic rules on thin capitalisation ... 239
IV.A. General ... 239
IV.B. 'Interest' ... 241
IV.C. Examples ... 244
a. Article 54 ITC ... 244
b. Article 26 ITC ... 250
IV.D. Case law ... 253
a. Millennium Infocom Technologies ... 253
b. Specialty Manufacturing ... 254
F. Article 24(5): foreign ownership ... *257*

I. Entitlement to Art. 24(5) ... 257
I.A. General ... 257
a. The wording of Art. 24(5) ... 257
b. Indirect ownership: Re A Oy and B Oy ... 258
I.B. Only the resident company is protected ... 259
a. Example: imputation systems vs split-rate systems ... 260
b. Group treatment ... 263
I.C. Discrimination on the basis of foreign ownership ... 265
a. On the basis of ... 265
b. On the sole basis of? ... 266
c. Application of these principles ... 267
d. Example: the Swedish Supreme Administrative Court on the interpretation of 'solely' ... 269
II. The comparability-test: 'other similar enterprises' ... 274
II.A. Similarity as a reference to shareholders' residence? ... 276
II.B. Similarity as a reference to the applicable tax regime? ... 277
II.C. Similarity as a reference to all relevant circumstances other than foreign ownership ... 279
II.D. Case law ... 280
a. Swedish Supreme Administrative Court 19 November 1987 ... 280
b. Dutch Supreme Court 23 December 1992 ... 280
c. Dutch Supreme Court 27 April 1994 ... 281
d. Boake Allen ... 288
e. DaimlerChrysler India ... 298
f. UnionBanCal ... 301
g. Square D ... 304
h. FCE Bank ... 305
III. The disadvantage-test: 'other or more burdensome' ... 308
III.A. General ... 308
a. The origin of the expression ... 308
b. Interpretation ... 309
III.B. Case law ... 311
a. The Delaware case ... 311
b. Luxembourg Administrative Court of Appeal 19 April 2007 ... 316
c. The Swedish Supreme Administrative Court on the interpretation of 'other' ... 318
IV. Relationship to Article 24(4) ... 319
IV.A. General ... 319
IV.B. Case law ... 321
a. Andritz ... 321
G. Article 24(6): taxes covered ... *329*
I. General ... 329
II. Case law ... 330
II.A. Dutch Supreme Court 1 November 2000 ... 330
H. The concurrent application of different provisions of Art. 24 OECD MC ... *333*
I. Article 24(1) and Article 24(3) ... 333
II. Article 24(1) and Article 24(4) ... 334
III. Article 24(1) and Article 24(5) ... 335
IV. Article 24(3) and Article 24(4) ... 337
V. Article 24(3) and Article 24(5) ... 337
VI. Conclusion ... 338

PART III: NON-DISCRIMINATION IN EUROPEAN TAX LAW ... 339

1. GENERAL OVERVIEW OF THE ECJ'S APPROACH TO NON-DISCRIMINATION ... 339
A. The Court's Aristotelian understanding of non-discrimination ... *343*
I. Overview ... 343
II. Methodology ... 344
B. Types of discrimination ... *346*
I. Discrimination in form – discrimination in substance ... 346
II. Direct – indirect discrimination ... 347
III. Reverse discrimination ... 348
III.A. The Court's traditional position ... 348
III.B. Later evolution and criticism ... 349
IV. Quantitative restrictions and measures having equivalent effect ... 351
V. Dassonville extended to other freedoms ... 354
VI. Conclusion ... 355
2. NON-DISCRIMINATION IN EUROPEAN TAX LAW ... 356
A. Introduction ... *356*
I. Purpose and scope of the study ... 356

II. The case law of the European Court of Justice on direct taxation 357
B. Comparable situations *359*
C. Equal treatment *360*
D. Types of discrimination *361*
I. Direct – indirect discrimination 361
II. Reverse discrimination 362
V. Is the ECJ's case law in direct tax matters still based on a discrimination-analysis, or has it evolved towards a restriction-based reading of the Treaty? 362
V.A. Restrictions: a similar evolution in direct tax case law? 362
V.B. From discrimination to restriction and back 365
a. Introduction: three generations of cases 365
b. The second generation: a restriction-based reading of the Treaty freedoms 366
c. The third generation: the return to discrimination 368
V.C. Most 'restriction-cases' are actually discrimination-cases in disguise 371
a. Discrimination on the basis of the exercise of the free movement provisions 371
b. Examples 375
c. Futura 377
d. Commission v Belgium 382
e. Conclusion 385
V.D. Restriction and discrimination are complementary components of the freedoms 387
V.E. Conclusion 389
E. Case law *390*
I. Discrimination 390
I.A. Comparability 391
a. Constructing the comparison I: how to determine the subject and object of comparison? 391
1. The taxation of inbound permanent establishments 391
a. Avoir fiscal 392
b. Commerzbank 396
c. Futura 397
d. Royal Bank of Scotland 398
e. Saint Gobain 400
f. CLT-UFA 404
g. Conclusion 406
2. Horizontal comparisons 408
b. Constructing the comparison II: what are the relevant characteristics? 410
1. Person-related benefits: incomparability is the general rule 411
a. The Schumacker-doctrine 411
1. Schumacker 411
2. Wielockx 416
3. Asscher 416
4. Gilly 418
5. Gschwind 424
6. De Groot 426
7. Gerritse 430
8. Wallentin 435
9. The D-Case 436
10. Turpeinen 440
b. Extension of the Schumacker-doctrine to negative income from immovable property 441
1. Ritter-Coulais 441
2. Lakebrink 444
3. Renneberg 446
c. Should Schumacker be overturned? 451
d. Conclusion 458
2. Income-related benefits: comparability is the general rule 463
a. Biehl and Biehl II 463
b. Gerritse 463
c. Conijn 464
d. Scorpio 464
e. Bouanich 466
f. Gielen 466
g. Conclusion 468
3. The taxation of outbound permanent establishments 468
a. AMID: comparability is the general rule 468
b. Columbus Container Services 470
c. Lidl Belgium 471
d. Krankenheim 472

4. The tax treatment of resident parent companies with non-resident subsidiaries: discrimination on the basis of the subsidiary's seat ... 474
a. ICI ... 474
b. X AB and Y AB ... 475
c. Bosal ... 477
d. Marks & Spencer ... 481
e. Keller and Rewe: Marks & Spencer confirmed ... 483
f. Papillon ... 487
g. X Holding ... 489
h. Conclusion ... 490
5. The tax treatment of resident subsidiaries with a non-resident parent company: discrimination on the basis of the parent company's seat ... 491
a. Metallgesellschaft ... 491
b. X and Y ... 494
c. Thin Cap GLO ... 495
d. Conclusion ... 496
6. The taxation of dividends: the susceptibility to double taxation as the relevant characteristic ... 497
a. Introduction ... 497
b. Inbound dividends: the susceptibility to double taxation as the relevant characteristic ... 497
1. Verkooijen ... 498
2. Lenz ... 499
3. Manninen ... 502
4. Are Verkooijen, Lenz and Manninen identical? Fiscal cohesion and inbound dividends ... 504
5. Kerckhaert-Morres ... 511
6. Orange European Smallcap ... 518
7. Test Claimants in the FII Group Litigation ... 522
8. Conclusion: the ECJ's position on inbound dividends ... 528
c. Outbound dividends: the exercise of taxing jurisdiction by the source State ... 529
1. Test Claimants in Class IV of the ACT Group Litigation ... 529
2. Denkavit ... 541
3. Amurta ... 543
4. Orange European Smallcap ... 544
5. Aberdeen ... 545
6. Conclusion: the ECJ's position on outbound dividends ... 546
7. Withholding taxes on other outbound payments ... 547
a. Scorpio ... 548
b. Truck Center ... 550
8. The influence of information exchange on the comparability-test ... 560
a. Talotta ... 560
b. Information exchange and third countries ... 565
1. FII: the inapplicability of the Mutual Assistance Directive leads to incomparability ... 565
2. A: FII explained ... 566
3. Commission v Netherlands: confusion concerning EEA countries ... 570
4. Commission v Italy ... 573
5. Conclusion ... 575
9. The influence of tax treaties on the comparability-test ... 576
a. The D-Case ... 576
b. ACT ... 582
c. Orange European Smallcap ... 584
d. Interim conclusion: reciprocity and the balance of tax treaties in the comparability-test ... 588
1. The importance of the concepts of reciprocity and the balance of tax treaties in the ECJ's case law ... 588
2. Distinguishing D and ACT from the earlier case law ... 590
3. Has the possibility of horizontal discrimination been created by the evolution in the ECJ's case law? ... 595
e. Horizontal comparability if the disadvantage is not caused by a tax treaty? ... 596
1. Cadbury Schweppes ... 596
2. Columbus Container Services ... 600
f. Conclusion ... 604
10. The comparability of charitable organisations ... 607
a. Stauffer ... 607
b. Persche ... 609
c. Conclusion ... 611
c. Conclusions on comparability ... 612
I.B. The disadvantage-test ... 615
a. Introduction ... 615
1. The deceptive simplicity of the disadvantage-test ... 615

2. The position of the test in the Court's case law ... 617
b. In general: what is a disadvantage? ... 618
1. FII: the disadvantage is inherent in a system that is compatible with the Treaty freedoms ... 620
2. Columbus Container Services: an application of the *FII*-nuance ... 622
c. The relevance of offsetting advantages in the State the tax system of which is under scrutiny ... 625
1. Avoir fiscal ... 625
2. Commerzbank ... 627
3. Saint-Gobain ... 629
4. CLT-UFA ... 629
5. Asscher ... 631
6. Talotta ... 633
7. Lakebrink ... 633
8. Cadbury Schweppes ... 634
d. The relevance of offsetting advantages in another State ... 635
1. Eurowings ... 635
2. Verkooijen ... 636
3. Lenz ... 636
4. De Groot ... 637
e. The relevance of tax treaties in the disadvantage-test ... 638
1. Avoir Fiscal ... 638
2. Manninen ... 638
3. Bouanich ... 639
4. ACT ... 640
5. Denkavit ... 641
6. Amurta ... 642
7. Thin Cap GLO ... 643
8. Commission v Italy ... 644
f. Conclusion: the Court's position on offsetting advantages ... 644
g. Procedural remedies to remove the disadvantage ... 648
1. Biehl and Biehl II ... 649
2. Schumacker ... 650
3. Gielen ... 650
4. Conclusion ... 652
I.C. The equal treatment of incomparable situations ... 653
a. Comparability ... 654
1. Mertens ... 654
2. Burda ... 655
b. The disadvantage-test ... 660
1. General ... 660
2. Deutsche Shell ... 660
c. Conclusion ... 661
II. Disparities ... 662
II.A. General ... 662
II.B. Dislocations ... 663
II.C. Case law ... 664
a. Gilly ... 664
b. Saint Gobain ... 667
c. Schempp ... 672
F. Conclusions ... *678*
I. On comparability: a plea for fractional taxation ... 678
II. Comparability should be distinguished from proportionality ... 680
III. How to distinguish justification-grounds from elements of comparability ... 681
III.A. General ... 681
III.B. Fiscal cohesion ... 684
a. Back to Bachmann ... 684
b. Later evolution: the requirement of a direct link ... 689
c. Manninen: relaxing the direct link-requirement ... 692
d. Conclusion ... 694
e. From cohesion to comparability? ... 695
3. CAN THE ECJ'S ANALYSIS BE IMPROVED? LESSONS FROM THE U.S. SUPREME COURT ... 696
A. Introduction ... *696*
I. A weakness in the ECJ's analysis ... 696
II. The case law of the U.S. Supreme Court and its relevance for the ECJ ... 696
B. A Kantian concept: the Commerce Clause as the first formulation of the categorical imperative ... *699*
I. Introduction ... 699
II. The Supreme Court's interpretation of the Commerce Clause ... 700
II.A. General ... 700

II.B. Early developments ... 701
II.C. The four-part test of Complete Auto Transit ... 702
II.D. Internal Consistency and the Commerce Clause ... 704
a. The origin of the internal consistency test: Container Corp. ... 704
b. Armco Inc. ... 705
c. Tyler Pipe ... 707
II.E. Internal consistency as a Kantian concept: can the measure be universalised? ... 708
C. ICT as a tool for identifying disparities ... 711
D. Limitations of ICT ... 716
E. Conclusion ... 718

PART IV: COMPARISON AND INTERACTION ... 720

1. A COMPARISON OF ART. 24 OECD MC AND THE ECJ'S NON-DISCRIMINATION STANDARD ... 720
A. Scope of application ... 720
I. Nationality discrimination: a comparison with Art. 24(1) ... 721
II. Inbound PE cases: a comparison with Art. 24(3) ... 722
III. Outbound payments: comparison with Art. 24(4) ... 725
IV. Discrimination on the basis of the parent company's residence: comparison with Art. 24(5) ... 726
IV.A. General ... 726
IV.B. Boake Allen – Metallgesellschaft ... 727
V. Disadvantage-test ... 729
VI. Conclusion ... 730
B. Justification grounds ... 732
2. THE INTERACTION BETWEEN THE ECJ'S STANDARD AND TAX TREATIES ... 735
A. General ... 735
B. The interpretation of Art. 24 OECD MC in EU Member States ... 736
I. Case law ... 736
I.A. General ... 736
a. The comparability of non-profit organisations ... 742
b. Bundesfinanzhof 8 September 2010 ... 745
c. Dutch Supreme Court 8 February 2002 ... 747
d. Verwaltungsgerichtshof 16 February 2006 ... 747
e. The Delaware case ... 750
f. Conclusion ... 751
II. Should the interpretation of Art. 24 be influenced by the ECJ's case law? ... 751

PART V: SUMMARY AND GENERAL CONCLUSIONS ... 757

Part I: Introduction

The verb "to discriminate" originates from the Latin verb *discriminare*, which is derived from *discernere*, a verb composed of *dis-*, meaning "off" or "away" and *cernere*, meaning "to distinguish", "to separate" or "to sift"[1]. The original meaning of the term was therefore entirely neutral, referring only to the making of a distinction or a division.

Nevertheless, 'discrimination' is now generally interpreted in an axiologically negative manner, i.e. a treatment which is less favourable[2]. As a result of this interpretation, a prohibition of discrimination amounts to a prohibition of treatment which is less favourable. Consequently, treatment which is more favourable is not precluded by a prohibition of discrimination. Strictly speaking, therefore, a prohibition of discrimination is not the same as a requirement of equal treatment. The former does not preclude reverse discrimination, while the latter does not allow for any differentiation: only equal treatment is allowed; nothing more, nothing less. Consequently, even though both concepts are obviously related, there is a subtle difference between the principle of non-discrimination and the principle of equality[3].

A semantic clarification may be in order here. Throughout the text of this study, a distinction is made between 'principles', 'rules' and 'standards'. The term 'principle' is used to refer to an abstract idea on how persons or States should conduct themselves. For instance, a principle of non-discrimination prohibits that certain protected situations are treated less favourably than other, comparable situations. A 'rule' is a concrete expression of a principle. For instance, Article 24 OECD MC is a non-discrimination rule, i.e. that provision is an expression of a non-discrimination principle. Similarly, the fundamental freedoms as they

---

[1] Oxford English Dictionary: *To discriminate: […] 3. a. intr. or absol. To make a distinction; to perceive or note the difference (between things); to exercise discernment. spec. To exercise racial discrimination […] **1866** A. JOHNSON Speech 27 Mar. in H. S. Commager Documents Amer. Hist. (1935) II. 16/2 Congress can repeal all State laws discriminating between whites and blacks in the subjects covered by this bill. […] b. to discriminate against: to make an adverse distinction with regard to; to distinguish unfavourably from others. […] **1880** MARK TWAIN (Clemens) Tramp Abr. II. 153, I did not propose to be discriminated against on account of my nationality. **1885** Pall Mall. G. 24 Feb. 8/1 The action of the German Government in discriminating against certain imports from the United States. **1886** Ibid. 19 July 3/2 If the police, as the Socialists declare, discriminate against them on account of their opinions."*

[2] This usage was first recorded in 1866; see the definition of the Oxford English Dictionary, quoted above. Compare for instance Webster's American Dictionary of the English Language of 1828 with Webster's Revised Unabridged Dictionary of 1913. In 1828, the definition of 'to discriminate' was: *"Transitive verb: 1. To distinguish; to observe the difference between; as, we may usually discriminate true from false modesty; 2. To separate; to select from others; to make a distinction between; as, in the last judgment, the righteous will be discriminated from the wicked; 3. To mark with notes of difference; to distinguish by some note or mark. We discriminate animals by names, as nature has discriminated them by different shapes and habits. Intransitive verb: 1. To make a difference or distinction; as, in the application of law, and the punishment of crimes, the judge should discriminate between degrees of guilt; 2. To observe or note a difference; to distinguish; as, in judging of evidence, we should be careful to discriminate between probability and slight presumption"* In the 1913 edition, the following was added: *"2. (a) To treat unequally. (b) (Railroads) To impose unequal tariffs for substantially the same service."*

[3] It should be noted from the outset that this distinction is not always made. The European Court of Justice, for instance, seems to perceive the prohibition of discrimination as a mere enunciation of the principle of equality (e.g. joined cases C-117/76 and 16/77, *Ruckdeschel v Hauptzollamt Hamburg-St. Annen*, 19 October 1977, *ECR* 1977, 1753, § 7). As the ECJ uses the terms interchangeably, it has been argued that the distinction is irrelevant in the context of the European free movement provisions (e.g. G. BARRETT, "Re-examining the concept and principle of equality in EC law", *Yearbook of European Law* 2003, 130; T. TRIDIMAS, *The general principles of EC law*, Oxford, Oxford University Press, 1999, 42). However, given the different obligations imposed by both principles, I disagree with that view.

have been interpreted by the ECJ are also non-discrimination rules, in that they express an underlying non-discrimination principle. Finally, a 'standard' is the test applied by a rule in order to determine whether it has been complied with. For instance, in order to determine whether a non-discrimination rule has been complied with, the most natural test would be to first determine whether the situations at issue are comparable, and then whether the subject of comparison incurs a disadvantage as compared to the object of comparison. But that basic framework may be interpreted and applied in different ways.

The ultimate goal of this study is to identify whether there is a common principle of non-discrimination that underlies both the non-discrimination rule of Art. 24 OECD MC and the non-discrimination rule as expressed in the ECJ's case law on the fundamental freedoms. In order to do so, the standards used in the application of both rules will be compared.

A. Aristotle's concept of distributive justice

The concept of equality, as it has been traditionally understood in Western culture, can be traced back to Aristotle's concept of distributive justice. According to Aristotle, *"equality in morals means this: things that are alike should be treated alike, while things that are unalike should be treated unalike in proportion to their unalikeness. […] Equality and justice are synonymous: to be just is to be equal, to be unjust is to be unequal."* [4]

The simplicity of this concept renders it attractive, but at the same time difficult to apply: without knowing what is alike and what is not, it is impossible to assess whether a treatment is discriminatory. It is precisely this issue of comparability that renders the practical application of the Aristotelian notion of equality quite difficult. Only abstract notions can be absolutely equal (for instance, the concept of equality in mathematics). In real life, however, two situations will always differ in some respects.

'Alike', therefore, will in practice translate to 'comparable'. That is to say, two situations will be considered to be alike when their relevant characteristics are the same. Determining the comparability of situations thus boils down to determining the relevance of the characteristics that they share: in order to determine whether two situations are comparable, it must be assessed whether their sameness (or difference) is relevant in the specific context at issue.

As a result, the strength of the Aristotelian concept of equality is also its weakness: choosing which elements of equality or inequality should prevail, can in practice lead to irresolvable dilemmas. It is quite possible that two situations can be held to be comparable and incomparable at the same time, depending on which characteristics one chooses to stress. This way, equality becomes an empty framework, in which every argument can be constructed as an argument for equality. Equality is thus reduced to an empty vessel with no substance of its own[5].

---

[4] Aristotle, *Ethica Nicomachea (Translated by W.D. Ross)*, London, Oxford University Press, 1925, V.3.1131a-1131b as summarized by P. WESTEN, "The empty idea of equality', *Harvard Law Review* 1982, Vol. 95, 543. Notwithstanding his idea that 'equality and justice are synonymous', Aristotle had no difficulty with the concept of slavery. For that reason, Russell has described Aristotle as *"no believer in equality"* (B. RUSSELL, *History of Western Philosophy*, London, George Allen & Unwin Ltd, 1961, 200).

[5] See e.g. P. WESTEN, "The empty idea of equality", *Harvard Law Review* 1982, vol. 95, 546-548

Yet, the fact that equality has no substance of its own does not mean it has no value at all. It is true that we do not aspire to equality for the mere sake of equality: we desire equality because certain inequalities are morally unacceptable. Equality derives its substance from the underlying moral values: it is only because we find these moral values worth protecting that we consider that situations should be treated equally with regard to these values. This, however, does not make the concept of equality superfluous. Equality is an instrument to attain morally desirable goals, it is a way to assess various conflicting aims. The concept of equality provides us with a framework in which we can test whether a measure is compatible with moral values that we wish to protect. This test can be difficult to apply in practice, but that in itself is no valid reason to abandon it. In other words, the Aristotelian understanding of non-discrimination is not an empty vessel, but an analytical framework that functions as a tool for testing the fairness of a measure.

That is also the case for the two emanations of the non-discrimination principle that are discussed in this study, i.e. Art. 24 OECD MC and the test developed by the ECJ in its case law under the fundamental freedoms. It is clear that those provisions are not intended to ensure non-discriminatory treatment as an end in itself, but rather as a means to an end. In particular, both concepts start from the assumption that removing discrimination will stimulate free trade by ensuring equal conditions of competition.

As pointed out above, the main difficulty in applying the principle of non-discrimination is deciding which characteristics are relevant when comparing two situations. Consider, for instance, the ECJ's different approach towards the comparability of non-residents and residents in the context of income-related tax benefits[6] and in the context of person-related tax benefits[7]. That different approach might seem confusing in light of the principle that "comparable situations must be treated equally". If non-residents and residents are comparable in the first case, then why would they not be comparable in the second case? In mathematics, two symbols that are mathematically equal in a given context (e.g. $1 + 1 = 2$), are equal in other contexts as well. But that is not necessarily true in the context of law and morals: the features two situations have in common can be made relevant by the specific context of the measure at issue. To say that two persons are equal in a given context, does not automatically imply that they will be equal in any other context.

B. Basic principles of discrimination

I. Elements of the discrimination-analysis

From the outset, it should be noted that this study is mainly concerned with the **existence** of a discriminatory treatment. The question as to whether the discrimination can be justified will only be addressed if it is relevant for the inquiry into comparability or equal treatment.

Four main elements can be distinguished in the basic Aristotelian concept of discrimination: (1) two situations (2) are treated differently (3) even though they are comparable, (4) resulting in a disadvantage for one situation. The opposite of (2) and (3), i.e. the equal treatment of two

[6] See the *Biehl* case and subsequent case law, discussed in Part III, 2.E.I.A.b.2.
[7] See the *Schumacker* doctrine, discussed in Part III, 2.E.I.A.b.1.

incomparable situations, is discriminatory as well. That type of discrimination can be referred to as 'discrimination by equal treatment'[8].

(1) The first element seems so obvious that it is often overlooked. The existence of two situations or two categories of persons creates the possibility to treat them differently. In order for there to be two situations, at least one quality or characteristic should be different. If not, both groups would be identical and discrimination would be impossible. Consequently, 'comparability' should be distinguished from 'identity.' When two situations are identical, they are equal in all their characteristics. Since no difference can be discerned, no different treatment can be applied. Comparable situations, on the other hand, differ in at least one aspect, but are identical in other aspects. The principle of non-discrimination thus concerns situations that are different enough to be distinguished, but comparable enough to deserve equal treatment.

In the remainder of this study, I will refer to these two situations or categories as 'the subject of comparison' and 'the object of comparison'. The subject of comparison is the situation or category which is protected by the non-discrimination rule. The object of comparison is the situation or category which is used as the benchmark in assessing whether discrimination has occurred. As a simple example, the subject of comparison could be non-national taxpayers. The obvious object of comparison would then be national taxpayers. Throughout this study, it will become apparent that it is often difficult to introduce analytical distinctions to clarify the discrimination-test. The distinction drawn here is no exception to this rule. The simple example of non-national taxpayers as compared to national taxpayers already demonstrates that the first element of the basic Aristotelian discrimination-concept (the existence of two situations) is closely interwoven with the second element (the comparability, i.e. the determination of the relevant characteristics; see infra). By choosing a subject and an object of comparison, two characteristics have already been included in the comparison, one which is identical and one which is different. The choice of non-national taxpayers as compared to national taxpayers implies that the nationality of the subject and object of comparison differs, whereas their character as taxpayer (i.e. their obligation to pay taxes in the State whose legislation is being scrutinized) is identical. As will become apparent below, the determination of the characteristics which are relevant to the comparison is essential in the discrimination-test. It should be borne in mind, however, that this determination can never be carried out *in vacuo*: the choice of the subject and object of comparison already has a significant impact on the characteristics to be included in the comparison.

Due to the nature and purpose of the non-discrimination concept, the subject and object of comparison always go hand in hand. Every non-discrimination rule intends to protect a category or a group from unfavourable treatment. This protected group is always characterized by a common characteristic (e.g. skin colour, nationality, place of residence,

[8] Of course, it could be said that the treatment of the subject and object of comparison is not entirely 'equal' in such a case, since the measure at issue works to the disadvantage of the subject of comparison. That is to say, because the subject of comparison is incomparable to the object of comparison, the application of identical rules to both results in a disadvantage for the former. So to that extent, the treatment is not 'equal'. Nevertheless, the term 'discrimination by equal treatment' is used because the discrimination consists precisely of the fact that the measure at issue does not distinguish even though it should do so, i.e. because it treats incomparable situations equally. As a side-note, it should be observed that any difference in treatment may impede the EU internal market's objective of creating a level playing field. In this respect, reference should also be made to the specific issue of reverse discrimination (see Part III, 1.B.III)

etc.). I call this common characteristic 'the comparative attribute'[9]. When assessing whether discrimination occurs, the protected group (the subject of comparison) is compared to the object of comparison, i.e. a group which is identical in all relevant aspects, other than the comparative attribute[10].

For instance, if a non-discrimination rule is intended to protect white people, the subject of comparison consists of all white persons, whereas the object of comparison consists of all non-white persons who are identical to the subject of comparison in all other relevant aspects[11]. In this comparison, the comparative attribute is the pigmentation of the skin (which, for purposes of this comparison, may have two values: white or non-white). Similarly, if a non-discrimination rule intends to protect non-residents (the subject of comparison), the object of comparison consists of residents who are identical to the subject of comparison in all relevant aspects other than their non-residence. In this comparison, the comparative attribute is the residence of the State whose legislation is under scrutiny (which, for purposes of this comparison, may have two values: resident or non-resident). Thus, in respect of the comparative attribute, the subject and object of comparison are always each other's mirror images.

(2) In order for there to be discrimination, a differentiation must be made: when a measure is entirely neutral, and does not distinguish on any basis, there is generally no discrimination. However, it is possible that a measure which does not distinguish on any basis is nevertheless discriminatory because it treats incomparable situations identically ('discrimination by equal treatment').

Moreover, in order for there to be 'direct' discrimination, the differentiation must occur on the basis of the criterion which the non-discrimination rule seeks to protect (e.g. nationality)[12]. For instance, there is clearly direct discrimination on the basis of nationality if a State grants a tax benefit exclusively to its own nationals. Yet, direct tax legislation is generally less clear-cut. States often implement measures which ostensibly distinguish on the basis of a 'neutral' criterion, for instance residence, but which generally have the same effect as a distinction on the basis of a prohibited criterion. This type of discrimination can be referred to as 'indirect' discrimination.

That being said, it is a common misunderstanding that discrimination rules are, as a matter of principle, inherently limited to direct discrimination. In other words, it is often assumed that a rule that, for instance, protects non-nationals from discrimination only prohibits discrimination **on the basis of** nationality. But that is not necessarily the case.

---

[9] This concept is also called the 'tertium comparationis' ("the third part of the comparison"), but because it is often misused, I will not use this term in order to avoid confusion.

[10] The determination of the relevant characteristic among both groups (i.e. the actual comparability-test) is the second step in the traditional Aristotelian understanding of discrimination (see hereafter).

[11] That is to say, if the non-discrimination rule is only concerned with direct discrimination: see hereafter.

[12] Throughout this study, the distinction between 'direct' and 'indirect' discrimination refers to discrimination specifically against the protected category or situation ('direct' discrimination) and to discrimination that is not expressly or specifically aimed at the protected category or situation but mainly affects that category or situation by its practical effect. That distinction is sometimes referred to in literature as 'overt' versus 'covert' discrimination. Additionally, the term 'indirect discrimination' is sometimes used in literature to refer to the situation where it is not the protected person himself but a related person who suffers from the unfavourable treatment. Throughout this study, that situation will not be referred to as 'indirect discrimination' but as 'derivative discrimination'.

Consider, for instance, the following non-discrimination rule: *"Non-nationals shall not be subject to less favourable taxation than nationals"*. If a measure grants tax benefits solely to residents, a non-resident non-national is not entitled to those benefits. Can that non-national invoke the non-discrimination provision in order to claim such a benefit? Strictly speaking, that should be the case. That is to say, if that non-resident non-national is compared to a resident national, it is clear that the non-national is treated less favourably than the national. And that is prohibited by the non-discrimination rule. The fact that the discrimination is not **on the basis of** nationality is not immediately relevant in this respect. On the basis of the text, the rule only tries to ensure that taxpayers who are in a certain situation (i.e. non-nationals) are not being treated less favourably than taxpayers who are in another situation (i.e. nationals). The rule does not say **which** nationals are considered to represent that standard of treatment to which the non-national is entitled. Strictly speaking therefore, the rule described here does not require all other elements (e.g. residence) to be the same.

In order for a non-discrimination rule to require that the distinction is made on the basis of the comparative attribute, the comparability test must be interpreted as strictly as possible. That is to say, the comparability test must then require all relevant elements other than the comparative attribute to be the same. In the example given above: for the non-discrimination rule to be restricted to direct discrimination, it is necessary that non-nationals are only entitled to non-discriminatory treatment as compared to nationals on the condition that they are identical in all relevant respects apart from nationality. And since non-resident nationals are not identical to resident nationals as regards residence, those categories are not comparable with the result that there is no discrimination.

On the other hand, if the non-discrimination rule were to be interpreted as also prohibiting indirect discrimination, the comparability test is relaxed. Assume that most non-nationals are non-residents. If tax benefits are granted exclusively to residents, most non-nationals will be unable to obtain those benefits. If the non-discrimination rule described above is interpreted as also prohibiting indirect discrimination, the non-national non-resident is nevertheless considered to be comparable to a resident national, despite the difference in residence. Given the close link between residence and nationality, that element is disregarded in the comparability test (see infra).

A related issue is that 'direct discrimination' is often interpreted as referring to 'direct discrimination on the basis of nationality'. But that is not necessarily the case. Every non-discrimination rule protects a certain situation or group of persons (the subject of comparison). If that rule is interpreted as being restricted to 'direct' discrimination, it would only prohibit measures that impose less favourable treatment solely on those situations or persons (that is to say, if all other relevant characteristics are the same: see supra). But if it is interpreted as also covering 'indirect' discrimination, it also prohibits measures that do not impose less favourable treatment only on the protected situations or persons but nevertheless mainly affect those situations or persons. The most obvious example is a rule that prohibits nationality discrimination. If it is interpreted as being restricted to direct discrimination, it would only prohibit measures that impose less favourable treatment solely on non-nationals. If it is interpreted as also covering indirect discrimination, it also prohibits measures that affect some nationals as well but nevertheless mainly affects non-nationals.

But that is not only the case for nationality non-discrimination rules. Consider, for instance, Art. 24(5) OECD MC. That provision prohibits discrimination against resident enterprises owned by residents of the other contracting State. So in that context, 'direct' discrimination is discrimination ‘on the basis of foreign ownership’. In contrast, a measure gives rise to ‘indirect discrimination’ in the context of Art. 24(5) if it does not distinguish on the basis of foreign ownership but nevertheless mainly affects resident enterprises owned by non-residents.

For that reason, it is not entirely correct to say that Art. 24(1) concerns direct discrimination while the rest of Art. 24 concerns indirect discrimination. It is true that Art. 24(1) concerns direct **nationality** discrimination, and that the other provisions could be seen as emanations of indirect **nationality** discrimination (in that, for instance, a measure discriminating against foreign-owned enterprises will mainly affect non-nationals). But at the same time, Art. 24(5) concerns direct **foreign ownership** discrimination, while Art. 24(4) concerns direct **outbound payment** discrimination. So the paragraphs of Art. 24 other than paragraph 1 should not be seen as mere emanations of the nationality non-discrimination rule. They are all individual non-discrimination rules that can hypothetically be interpreted either as a prohibition against direct discrimination or as also covering indirect discrimination. Whether the different paragraphs of Art. 24 allow for an interpretation that also covers indirect discrimination will be discussed in Part II.

(3) In assessing whether different treatment is discriminatory, the issue of comparability is, by far, the most complex one, because it is often excrutiatingly difficult to determine which aspects are relevant and which are not. When two situations are only identical with regard to aspects that are completely irrelevant, they are not comparable for the purpose of the non-discrimination test. For instance, two persons who differ in every aspect, save for the color of their shoes, cannot claim equal income tax treatment, as the color of one’s shoes is generally irrelevant for income tax purposes. The equality of their shoe color renders them comparable in some regards, but not in the context of income tax. Thus, it is clear that situations are never comparable *in abstracto*; the aspects that are relevant must be determined in light of the measure at issue. This implies that a given distinction may be found discriminatory in one legal area (e.g. tax law) but not in another legal area (e.g. family law), as the aspects determining the comparability of situations may differ among different legal areas. As a result, the question whether situations are comparable leads to a great deal of confusion.

In the tables used throughout this study, two comparable situations are represented as follows[13]:

$$\mathbf{A} \cong \mathbf{B}$$

At its very core, non-discrimination is a matter of fairness and, therefore, of justice. Ultimately, most modern systems of income taxation are based on the idea that persons who have an equal ability to pay should contribute equally. Ability to pay is not based on the principle that taxation should be levied in relation to the benefits an individual receives in

[13] I will use the following symbol to denote comparability: ≅. This symbol was first used in 1824 by the German mathematician Karl Brandan Mollweide to refer to congruence (F. CAJORI, *A history of mathematical notations – Vol. I: Notations in elementary mathematics*, Chicago, Open Court Publishing, 1929, 415). In Euclidean geometry, two figures are congruent if they have the same shape and size, but are in different positions. Apart from their position, the figures are identical in all relevant aspects. The properties which are identical among both figures are called ‘invariants’. Similarly, two comparable tax situations are identical in all relevant aspects, apart from their ‘position’ (i.e. the comparative attribute, for instance the taxpayer’s place of residence).

public services (benefit principle), but on the idea that everyone should make an equal sacrifice for the good of the community as a whole[14]. The basic criterion for non-discrimination should thus be ability to pay, nothing more, nothing less: just taxation is taxation that is entirely based on ability to pay. However, ability to pay is difficult to measure. The primary indicator of a taxpayer's ability to pay is generally understood to be his income, but this criterion is not entirely accurate. As will become apparent throughout this study, case law on non-discrimination only rarely uses ability to pay as the sole criterion for comparability. The criteria that are used instead are often only indirectly indicative of ability to pay. A great deal of inconsistencies and confusion in case law can be explained by this very intangible nature of ability to pay (see infra).

(4) The existence of a disadvantage is the final component of the analysis: the different treatment, referred to in (2), must lead to a disadvantage for the subject of comparison. If the different treatment does not result in a disadvantage for the subject of comparison, there is either equal treatment or the subject of comparison receives **better** treatment than the object of comparison. In the latter case, it may be possible that the non-discrimination rule governing the situation has specific effects as regards such situations of 'reverse discrimination'.

For instance, a rule prohibiting tax discrimination of non-residents as compared to residents may be interpreted as prohibiting reverse discrimination as well (i.e. tax discrimination of residents as compared to non-residents, for instance by granting certain tax advantages to the latter group, which are unavailable to the former group) if the rule is written in equal treatment-terminology (i.e. requiring equal treatment of residents and non-residents, no more, no less) rather than non-discrimination-terminology (i.e. prohibiting less favourable treatment of non-residents without expressly requiring equal treatment).

II. Proposal for an analytical framework

In order to apply the discrimination-analysis in a coherent and uniform manner, it is important to have a clear analytical framework in which the different issues can be addressed. In this section, I will set out a basic framework which can be used when analysing discrimination cases. The following flowchart represents the proper decision process when deciding whether there is discrimination.

---

[14] E.g. J. STUART MILL, *The principles of political economy*, 1870 (7th Edition), London, Book V, Chapter II: *"For what reason ought equality to be the rule in matters of taxation? For the reason, that it ought to be so in all affairs of government. As a government ought to make no distinction of persons or classes in the strength of their claims on it, whatever sacrifices it requires from them should be made to bear as nearly as possible with the same pressure upon all, which, it must be observed, is the mode by which least sacrifice is occasioned on the whole. If any one bears less than his fair share of the burthen, some other person must suffer more than his share, and the alleviation to the one is not, caeteris paribus, so great a good to him, as the increased pressure upon the other is an evil. Equality of taxation, therefore, as a maxim of politics, means equality of sacrifice. It means apportioning the contribution of each person towards the expenses of government, so that he shall feel neither more nor less inconvenience from his share of the payment than every other person experiences from his."*

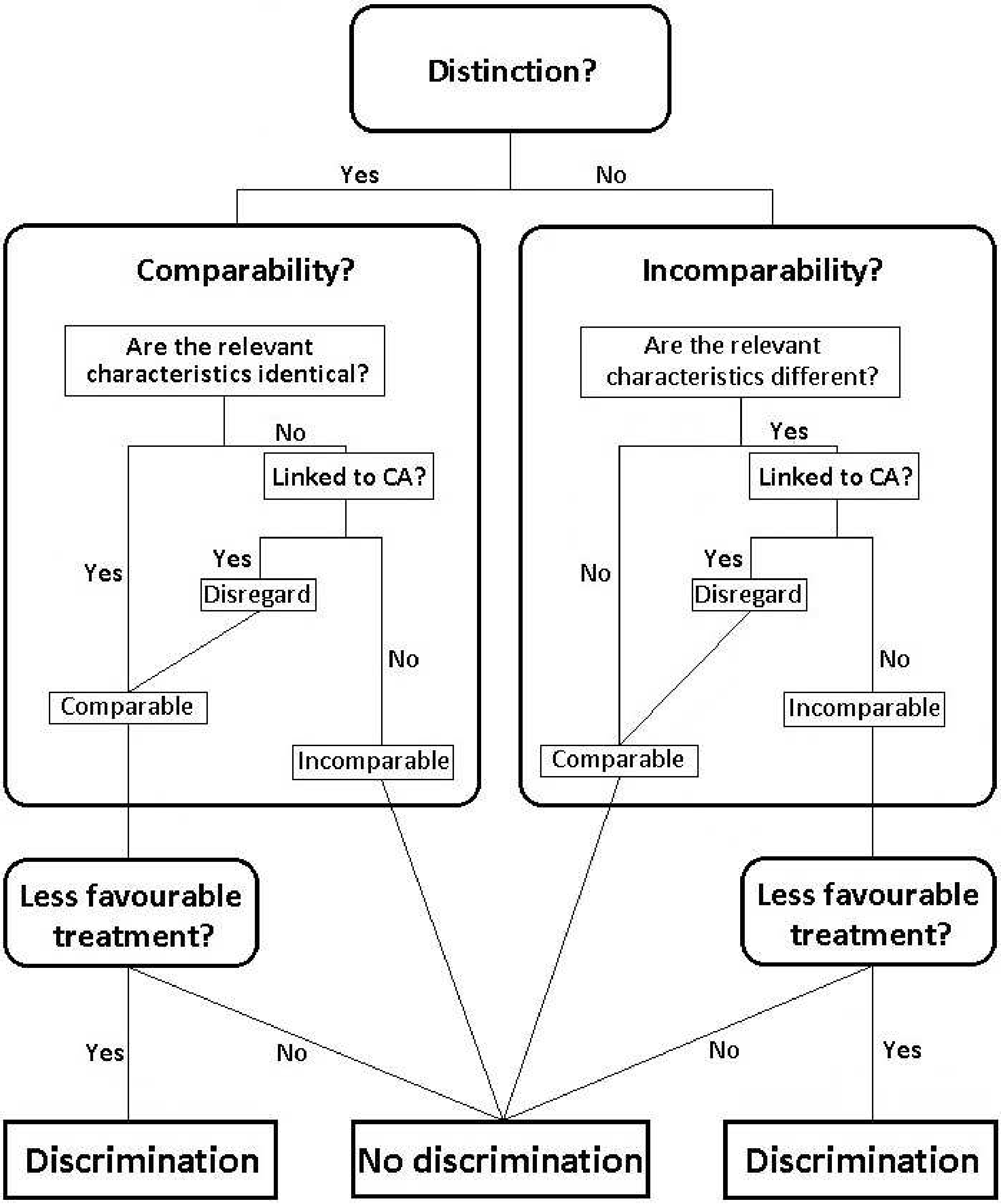


Table 1: The decision process in the discrimination analysis

1. As pointed out above, it should first be determined whether a **distinction** is made. If not, there is no discrimination (unless there is discrimination by equal treatment, see infra).

2. Secondly, one should verify whether the groups between which a distinction is made are **comparable**. In order to do so, it must be ascertained whether the characteristics that are **relevant** to the measure at issue are identical among both groups. If they are, the situations can be considered comparable.

On the other hand, if a relevant characteristic is found to be different between the subject and object of comparison, it is necessary to verify whether that characteristic is **linked to the comparative attribute**. If it is, it should be disregarded. If it is not, it renders the situations incomparable, which means that there is no discrimination.

Assume, for instance, that all nationals of a given State are called John, while all non-nationals of that State are called Steve. Furthermore, assume that a nationality non-discrimination rule applies. Given the identity of the variables nationality and name, it would make no difference whether that State discriminates on the basis of nationality or on the basis of being called John. But that does not imply that the non-discrimination rule is being interpreted as also precluding indirect discrimination. As pointed out earlier, for a rule to be restricted to direct discrimination, it is necessary that it only applies where the distinction is made on the basis of the comparative attribute. Consequently, the comparability-test under such a non-discrimination rule would amount to ensuring that **all relevant characteristics**, apart from the comparative attribute are identical. But if a relevant characteristic is **inextricably linked** to the comparative attribute, it should be disregarded. The reason is obvious. Accepting that a certain characteristic which is necessarily linked to the comparative attribute should be taken into account in the comparability test, would mean that the situations are automatically rendered incomparable. Since the subject and object of comparison are, by definition, different as regards the comparative attribute, all elements necessarily linked to the comparative attribute are also different between them.

The opposite approach would render any non-discrimination rule entirely ineffective. Assume that a State wants to discriminate against non-nationals, but is precluded from doing so by a non-discrimination rule. That non-discrimination rule would be rendered meaningless if the State in question could first enact a law that provides that *"from henceforth, all nationals shall be referred to as X"*, and then discriminate against every person who is not X.

For that reason, a rule which prohibits (direct or indirect) discrimination should disregard characteristics that are inextricably linked to the comparative attribute. 'Inextricably linked' means that the presence or absence of that characteristic depends entirely on the value of the comparative attribute. In other words, a characteristic is **only** inextricably linked to the comparative attribute if all the situations where the value of the comparative attribute is 0 (e.g. non-national) share that characteristic, while none of the situations where the value of the comparative attribute is 1 (e.g. national) have that characteristic.

A simple example might clarify this. Consider a national measure in State A which grants tax benefits to companies that are listed on the stock exchange of that State. In order to be listed on that stock exchange, companies must be resident of State A. However, not all resident companies are listed. The non-discrimination rule at issue prohibits discrimination against non-resident companies. In order to assess the comparability of the situations, it must first be determined whether being listed is relevant for the measure at issue. If it is not, there is nothing that renders the situations incomparable, with the result that there is discrimination[15]. However, if being listed is relevant for the measure at issue, the question arises whether being listed is inextricably linked to the comparative attribute, i.e. residence. In **all** the situations where the company is a non-resident (i.e. where the value of the comparative attribute is 0), is the characteristic absent (that is to say, non-resident companies are never listed). But the characteristic is **not** present in **all** situations where the company is a resident (that is to say, not all resident companies are listed). Therefore, it cannot be said that the relevant characteristic is inextricably linked to residence, since a number of residents are **not** listed. As a result, the characteristic 'being listed' renders the situations incomparable, meaning that there is no discrimination. An example of a characteristic that is inextricably linked to the comparative attribute could, for instance, be worldwide tax liability. Assume that all residents of a given State are subject to worldwide tax liability, while non-residents are never subject to such worldwide tax liability, then that characteristic would be inextricably linked with the comparative attribute residence and should therefore be disregarded under a residence non-discrimination rule.

Now assume that the non-discrimination rule also covers **indirect** discrimination. If the characteristic in question is relevant, the next question is no longer whether that characteristic is **inextricably** linked to the comparative attribute. Instead, the comparability depends on the **degree to which** indirect discrimination is prohibited. Applied to the example given above, assume that 90% of resident companies are listed, while non-resident companies are never listed. In that case, accepting there to be comparability would not imply giving the non-discrimination rule an extensive degree of 'indirect effect'.

> The expression 'indirect effect' in this context refers to the idea that, even though a distinction is not on the basis of the comparative attribute, it will nevertheless be to the disadvantage of the subject of comparison because of the link between the criterion that is used to distinguish and the comparative attribute. The most obvious example in tax matters is the link between residence and nationality. If a measure distinguishes on the basis of residence, it does not fall foul of a nationality non-discrimination clause that only applies to direct discrimination. However, since most non-nationals are also non-residents, that distinction will mainly affect non-nationals. If the nationality non-discrimination rule is interpreted as also prohibiting such indirect discrimination, it is given 'indirect effect'.

Consider, on the other hand, the situation where non-resident companies can also be listed on the stock exchange in question. Assume that 60% of resident companies are listed, while only 40% of non-resident companies are listed. Here, it could also be argued that most resident companies are listed, while most non-resident companies are not listed. Consequently, since the tax benefit is granted to listed companies, it will favour resident companies more than non-resident companies. But here, the 'indirect effect' of the non-discrimination rule is significantly greater than above.

In the flowchart, that possibility to shift from direct to indirect discrimination (and from 'stricter' to 'broader' indirect discrimination) takes place in the section 'Linked to CA'. If the rule is restricted to direct discrimination, the link between the relevant characteristic and the comparative attribute should be inextricable, i.e. necessary (if A, then also B; if non-A, then also non-B) for there to be a positive response to that section. But if the rule is also concerned with indirect discrimination, the link is relaxed. That is to say, the more liberal the approach

[15] Assuming that there are other relevant characteristics that are shared by resident and non-resident companies.

towards the indirect effect required for there to be discrimination, the sooner a characteristic will be considered to be linked to the comparative attribute (and therefore disregarded, meaning that the situations are comparable). In the examples given above: there is a difference between finding discrimination in the situation where 90% of residents are listed while no non-residents are listed, and where 60% of residents are listed while 40% of non-residents are listed. In the latter case, the indirect effect of the non-discrimination rule is considerably greater than in the former case. Clearly, this might introduce a degree of unpredictability in the non-discrimination test.

> Of course, it could be argued that the same result could be achieved by restructuring the flowchart. In particular, the following new step could be introduced in the analysis, between the step ‘Distinction’ and ‘Comparability’: ‘Distinction on the basis of CA’. That step allows to immediately discard cases where the distinction is made on another basis than the comparative attribute (e.g. worldwide tax liability). However, if such criterion is linked with the comparative attribute, it should be disregarded for the reason discussed above: otherwise, the non-discrimination rule would be rendered meaningless. The term ‘linked’ means the same in this context as above. Accordingly, if the rule only concerns direct discrimination, there must be a necessary link. But if the rule also concerns indirect discrimination, that requirement is relaxed depending on the degree of direct effect accorded to the rule. ‘Disregarded’ in this context means that the distinction at issue should be equated to a distinction on the basis of the comparative attribute.
>
> The result of disregarding the criterion would be that the discussion moves to the next step, i.e. the comparability test, which is applied in the same manner as above. Accordingly, it is possible that the criterion on the basis of which the distinction was made (e.g. worldwide tax liability) is a characteristic which is relevant for the measure at issue. In that case, it should once again be ascertained whether it is inextricably linked with the comparative attribute. If it is not, there is incomparability and, thus, no discrimination. If it is, it should be disregarded, with the result that the situations are comparable. As a result, the same issue would have to be addressed twice in the flowchart, which would complicate the analysis.
>
> Furthermore, adding such a new step in the decision process would not add anything to the analysis since it is exactly the same as the step in the comparability-analysis concerning the requirement of a link between the relevant characteristic and the comparative attribute. Indeed, determining whether a distinction is made on the basis of the comparative attribute is exactly the same as determining whether all relevant characteristics, apart from the comparative attribute, are identical. The same is true in case no distinction is made, i.e. when it needs to be determined whether there is discrimination by equal treatment. In that case, the new step in the decision process would amount to asking whether the situations are treated identically **because of** the comparative attribute. That is exactly the same as determining whether all relevant characteristics, apart from the comparative attribute, are different.

4. Having established that the situations are comparable, it is necessary to determine whether the distinction at issue results in less favourable treatment of the subject of comparison. As pointed out above, non-discrimination does not, strictly speaking, seek to achieve equality. It is merely a guarantee that the subject of comparison will not be treated less favourably than the object of comparison. If there is no less favourable treatment (i.e. if the subject and object of comparison are treated identically or if the subject of comparison is treated better than the object of comparison), there is no discrimination.

5. If the answer to the first question – i.e. whether there is a distinction – is in the negative, it must be determined whether there is discrimination by equal treatment. That would be the case if two situations that are incomparable are nevertheless treated identically. The incomparability of the situations is assessed in the same way as the comparability of the situations in case a distinction was made (supra). Here, however, the decisive question is **not** whether all the relevant characteristics are identical, but whether all the relevant characteristics are **different**. For instance, if residents and non-residents are treated identically for tax purposes, a residence non-discrimination rule requires an assessment as to whether those categories of taxpayers are incomparable. In that respect, an example of a relevant difference could be the fact that residents are subject to worldwide tax liability while non-residents are not. Once again, it should then immediately be determined whether that characteristic is linked to the comparative attribute. If that is the case, it should be disregarded, meaning that there is nothing to render the situations incomparable.

Here as well, the required link between the relevant characteristic and the comparative attribute can be relaxed in order to allow the non-discrimination rule to have indirect effect. That is to say, if the requirement of a link is interpreted strictly, meaning that there must be a necessary relationship between the comparative attribute and the characteristic in question, the rule is only concerned with direct discrimination. In that case, a characteristic can only be disregarded if the subject and object of comparison are always and necessarily different as regards that characteristic. In contrast, if a more indirect approach is taken, the required link could be relaxed, so as to also disregard characteristics which are 'mostly' different between subject and object of comparison.

III. A brief note on ability to pay

As pointed out above, the comparability of taxpayers will often be influenced by their 'ability to pay tax'. An exhaustive overview of the importance of the ability to pay principle in the context of income taxation goes well beyond the scope of this study. Nevertheless, it is helpful to give a brief overview of its interpretation.

The ability to pay principle states that every person should contribute to the public burdens in proportion to his 'ability'. So the greater one's ability to pay, the higher a fair tax should be. There are two aspects to this principle. On the one hand, the horizontal aspect of ability to pay (which is sometimes referred to as 'horizontal equity') means that all taxpayers with the same ability to pay should bear the same tax burden. On the other hand, the vertical aspect of ability to pay (which is sometimes referred to as 'vertical equity') implies that a person with a higher ability to pay should bear a higher tax burden than a person with a lower ability to pay. Non-discrimination is only concerned with the horizontal aspect: it only requires that persons who are in the same ability to pay-situation bear the same tax burden, it does not contain specific guidelines on how persons with higher ability to pay should be treated as compared to persons with lower ability to pay[16].

[16] Of course, it could be said that non-discrimination is also concerned with the vertical aspect of ability to pay, but only **indirectly**. Since the principle of non-discrimination requires incomparable situations to be treated differently (see supra), a person with a higher ability to pay should be taxed differently from a person with a lower ability to pay. But the non-discrimination principle does not describe **how** they should be treated. Consequently, it does not make a judgment in this context about tax rates, degree of progressivity, etc.

The idea that a person's tax burden should be determined by reference to his 'ability' is a principle that dates back to the Middle Ages[17]. Yet, even though there has long been broad agreement that taxation in accordance with ability to pay results in fair taxation, it is not immediately clear how a person's ability to pay ought to be determined. Originally, the most appropriate test for a person's ability to pay tax was thought to be his general property[18]. Later, however, the focus was shifted from property to income. This is reflected, for instance, in Adam Smith's idea that *"the subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state"*[19].

Gradually, the idea grew that ability to pay should be concerned with an equal sacrifice. That is to say, the ability to pay taxes was not simply measured as a proportion of income, but by that proportion of income, the loss of which would impose upon the taxpayer an equal burden or sacrifice with his neighbour[20]. As John Stuart Mill observed: *"As a government ought to make no distinction of persons or classes in the strength of their claims on it, whatever sacrifices it requires from them should be made to bear as nearly as possible with the same pressure upon all, which, it must be observed, is the mode by which least sacrifice is occasioned on the whole. […] Equality of taxation, therefore, as a maxim of politics, means equality of sacrifice. It means apportioning the contribution of each person towards the expenses of government, so that he shall feel neither more nor less inconvenience from his share of the payment than every other person experiences from his"*[21].

Of course, there are different ways to express the equality of sacrifice. The most straightforward idea is that of an equal absolute sacrifice, meaning that each taxpayer gives up the same absolute amount of income or, alternatively, that of an equal proportional sacrifice, meaning that each taxpayer gives up the same proportion of his income. However, an interpretation which is more in line with the purpose of the ability to pay principle is the idea of equal marginal sacrifice, which implies that every taxpayer sacrifices the same utility from the last unit of income[22]. This approach is based on the idea that the utility of the last unit of income falls as income rises. For instance, the utility of the last dollar or euro earned by a person with an income of 1,000 is less than the last dollar or euro earned by a person with an income of 10. In order to pay the same amount of taxes (either in absolute terms or in proportional terms), the low-income taxpayer might have to give up something essential, while the high-income taxpayer would have to give up a luxury. For that reason, it was argued

---

[17] Of course, the notion that taxation should correspond to ability had been uttered before, but it started playing a central role in the Middle Ages. An early example can be found in Livy's History of Rome, where it is mentioned that, around 500 B.C., the Roman Senate exempted the plebs from certain taxes, which were entirely placed on the rich *"who were able to bear the burden"* (TITIUS LIVIUS, *Ab urbe condita libri*, Liber II, 9: *"portoriisque et tributo plebes liberata, ut diuites conferrent qui oneri ferendo essent"*).

[18] For a historical overview, see E. SELIGMAN, *Essays in taxation* (5th ed.), New York, Columbia University Press, 1905, 37-54.

[19] A. SMITH, *An inquiry into the nature and causes of the wealth of nations*, Vol. II (2nd ed.), London, 1778, Book V, Chapter II, Part II, 425. Apart from the ability to pay principle, this statement also refers to the benefits principle, according to which taxpayers should pay for the public benefits they receive, just as they must pay for their private purchases. This principle will not be explored further here.

[20] E. SELIGMAN, "Progressive Taxation in Theory and Practice", *American Economic Association Quarterly*, 1908, 3rd Series, Vol. 9, No. 4, 209-210.

[21] J. STUART MILL, *The principles of political economy*, 1870 (7th Ed.), London, Book V, Chapter II.

[22] See e.g. A. PIGOU, *A study in public finance* (3rd Ed.), London, Macmillan, 1960, 43-44.

that taxes should be increased on the high-income taxpayer and decreased on the low-income taxpayer until both make the same marginal sacrifice[23].

In addition, it could be argued on this basis that the appropriate benchmark for a taxpayer's ability to pay is not his income as such, but only that part of his income that exceeds what is necessary for his existence. Only the part of a taxpayer's income that exceeds the minimum of subsistence should therefore be taken into account when determining his ability to pay tax[24].

However, the idea of equal marginal sacrifice as described above rests on the assumption that utility of income declines in an observable manner, which is similar for all taxpayers. Clearly, that idea is unrealistic, with the result that it may be difficult, if not impossible, to find a benchmark that defines ability to pay in every conceivable situation. For instance, it is clear that a taxpayer's actual ability to pay tax is also affected by a number of personal circumstances, such as marital status or having children: the minimum of subsistence for a taxpayer with children is higher than that of a childless taxpayer. In order to achieve a fair distribution of tax burdens between them, that aspect should be taken into account.

Despite there being some debate on the interpretation of the ability to pay principle, it is quite straightforward to apply within one State. It is very difficult, however, to apply this principle where two or more States are involved. For instance, a taxpayer earning income in two States may be faced with divergent legislation on tax benefits for child-care. The question then arises if and to what extent the principle of non-discrimination requires the States involved to grant the relevant benefits under their legislation. As will become apparent throughout the discussion of the relevant case law, this question gives rise to intricate issues.

C. Overview of the study

This study is concerned with the interpretation and application of the non-discrimination principle in direct tax matters, from an international and European perspective. However, not every single expression of the non-discrimination principle in those two spheres will be addressed. Instead, the study analyses the non-discrimination standard used in tax treaty practice and the non-discrimination standard used by the European Court of Justice ('the ECJ') in its application of the fundamental freedoms in direct tax matters[25]. Both standards

[23] Reference should be made in this context to the 'Engel curve' (after the German economist Ernst Engel), which describes how a consumer's purchases of a given good varies as his income varies. It is used to illustrate that the lower the income, the higher the proportion of income used to purchase basic goods such as food.

[24] Of course, these arguments also have implications as to the appropriate tax rate. In particular, it could be argued that this interpretation of the ability to pay tax requires tax rates to be highly progressive. However, that aspect is not immediately relevant to the present discussion and will not be addressed here.

[25] National (constitutional) non-discrimination rules will not be addressed in this study. As will become apparent throughout the analysis of Art. 24 OECD MC and the standard underlying the fundamental freedoms, both non-discrimination standards are characterized by their pursuit to remove obstacles to interstate trade. Constitutional non-discrimination rules, by contrast, should be seen in the context of civil and political rights granted by the constitution to citizens of a given State. Thus, those rules generally do not seek to remove discriminatory obstacles to trade. Nevertheless, constitutional non-discrimination rules have been relied on in certain instances in order to remove discriminatory obstacles to inter-State trade. For an example, see the judgment of the Brussels Court of First Instance of 26 October 2007. At issue was the same Belgian regime which the ECJ declared incompatible with the fundamental freedoms in the *AMID*-case (see Part III, 2.E.I.A.b.3), but involving a PE in a third country (Nigeria). The Brussels Court of First Instance held that the Belgian regime infringed the Belgian constitutional non-discrimination rule and thus decided in favour of the taxpayer. Accordingly, the constitutional rule was successfully relied on in order to remove a discriminatory obstacle to interstate trade. For an extensive

will be analysed from the perspective of the two constituting elements of discrimination: comparability and different treatment.

After analysing both standards separately, a comparison will be made in an effort to determine whether there is a common underlying principle of non-discrimination.

Part II. Article 24 of the OECD Model Convention

The second part of this study will deal with Article 24 of the OECD Model Convention, on which the vast majority of non-discrimination provisions in tax treaties is based. As noted above, this study will not consider all the different expressions of the non-discrimination principle in international tax law, but will remain confined to tax treaty law and, more specifically, those tax treaties that are based on the OECD MC.

As will become apparent throughout the study of Article 24 OECD MC, it is based on the Aristotelian understanding of equality referred to above. As pointed out earlier, this understanding fundamentally consists of two separate elements: the (empirical) finding that two situations are comparable, and the (normative) conclusion that less favourable treatment is prohibited. Given its foundation in the Aristotelian concept of equality, the non-discrimination standard of Article 24 OECD MC is burdened with the inherent difficulties as to comparability that were set out above: comparability depends on determining which characteristics are relevant. A choice of different characteristics can lead to a different result of the comparability-test. An analysis of case law will demonstrate the importance of this issue.

The second element, the requirement of equal treatment, is problematic as well. In order to declare a measure discriminatory, it is necessary to demonstrate that the taxpayer is treated differently from a comparable taxpayer. Fundamental questions arise here as well, e.g. questions regarding the possibility for a State to refer to a compensatory measure which places the complaining taxpayer *de facto* in the same position as the object of comparison, questions regarding the relevance of the tax regime in other States (e.g. the existence of a favourable regime in the taxpayer's home State), etc.

If the measure at issue is found to be discriminatory – i.e. if comparable situations are treated differently – then the possibility to justify this discrimination must be investigated. Art. 24 OECD MC leaves something to be desired in this regard as well, as the provision does not allow States to advance grounds of justification for the contested measure. As a result, the Article may be applied as a strictly mechanical tool, without any margin for flexibility. An analysis of reported case law will reveal whether courts try to incorporate 'safety valves' in their reasoning under Art. 24, to compensate for the lack of justification grounds. More specifically, the question arises whether courts tend to conclude more quickly that the situations are not comparable. A second way to include a safety valve in Art. 24 OECD MC consists of concluding more quickly that the challenged measure does not lead to a different treatment. That is to say, one might argue in certain cases that the taxpayer is not being discriminated against, because his *overall* tax burden is not higher than the tax burden imposed on the object of comparison.

---

analysis of this decision, see L. DE BROE and N. BAMMENS, "The Belgian Velasquez doctrine in non-EU situations: an analysis under Belgian constitutional and treaty law", *Bull. IBFD* 2010, 10, 510-516.

Part III. Non-discrimination in the case-law of the ECJ

The third part of this study examines the application of the EU Treaty freedoms in the case law of the European Court of Justice in direct tax matters. Consequently, not every single expression of the idea of non-discrimination in European tax law will be discussed: this study is only concerned with the interpretation given to the non-discrimination principle by the ECJ, as expressed in its case law on the fundamental freedoms. The ECJ's case law in the area of direct taxation is characterised by a certain degree of judicial activism, which is most likely inspired by the lack of workable legislative tools in this field. Without passing judgment on the desirability of this judicial activism, it is necessary to determine whether the tools used are suited for the objective pursued.

An overview of the Court's case law will reveal that the non-discrimination standard used by the Court is based on the same Aristotelian idea of equality as Article 24 OECD MC. However, similar problems are sometimes solved differently because the standard developed by the ECJ has been given a much wider scope of application. Additionally, measures which fall foul of the European freedoms may be justified by advancing certain grounds of general interest. As indicated earlier, no such possibility exists under Art. 24 OECD MC. As a result, the decision process under both standards differs fundamentally. A comparative case law analysis reveals the importance of these differences. For instance, one might argue that the ECJ is less concerned with the comparability-test, because the third step of the decision tree (the justification-test) leaves a lot of elbow room. However, it is not advisable to intermingle both steps of the analysis: the comparability of the situations should not be influenced by the possible justification of a discriminatory measure. Consequently, a theoretically sound approach requires the comparability-test to produce identical results under both standards.

Furthermore, the partial overlap of the two non-discrimination rules may cause frictions. Intricate triangular situations are possible, with conflicting rules giving rise to interpretation problems. The tax treaty non-discrimination provision, which guarantees national treatment, may be at odds with the benefits granted by the EU Treaties to EU-citizens. After the ECJ's decision in the *D*-case[26], a heated discussion arose on the fragile balance between tax treaties and European law, the reciprocal nature of tax treaties, etc. Remarkably, the ECJ already considered these issues in its very first decisions in the field of direct taxation[27]. However, not all questions have been answered in a satisfactory manner. First of all, are EU-Member States, when applying Art. 24 OECD MC (either among themselves or in relations with third States) required to take the ECJ's case law into account, given the partial overlap between the rules? Secondly, can subjects of third States derive any rights from the interaction between the non-discrimination provision of the applicable tax treaty and the European freedoms?

A fundamental issue in the analysis of the ECJ's case law concerns the perception that the Court has evolved from a discrimination-based reading of the freedoms towards a restriction-based reading. Given this evolution, one may question the relevance of the object of this study for the ECJ's ever-expanding restriction-based case law. However, an overview of the relevant case law will reveal that the Court's analysis in most 'restriction' cases is based on the same non-discrimination-test as the traditional discrimination-based cases. Even though the object of comparison is different in both bodies of case law, the underlying test applied by the ECJ remains the same: in 'restriction' cases, the comparison is no longer made between a national of one Member State exercising his Treaty freedoms and a comparable national of

[26] C-376/03, *ECR* 2005, I-5821.
[27] E.g. C-270/83, *Avoir Fiscal*, § 23.

the Member State which (allegedly) discriminates, but rather between a national of a Member State exercising his freedoms, and a comparable national of the same Member State who does not exercise those freedoms[28]. Furthermore, the emergence of actual restriction-based cases does not mean that the discrimination-standard has been replaced. Instead, non-discrimination and non-restriction should be seen as complementary components of the fundamental freedoms that are both necessary to achieve an internal market.

Another issue that will become apparent throughout the analysis of case law, is that the ECJ sometimes fails to distinguish between cases of discrimination and so-called disparities. Differences in treatment caused by existing divergences between the laws of the Member States do not amount to discrimination if these laws apply on the basis of objective criteria and irrespective of the nationality of the persons involved[29]. The ECJ cannot remedy disparities: legislative harmonisation is required to achieve that goal. Consequently, the distinction between discrimination and disparity is of the utmost importance for the Member States' fiscal sovereignty. The EU Treaties prohibit the introduction of discriminatory tax measures, but Member States remain free to shape their tax regime as they wish, by determining tax rates and by defining the taxable base. However, the ECJ sometimes finds a measure to be discriminatory while the disadvantage is actually due to a disparity[30] (or *vice versa*[31]). Such decisions are not merely due to the Court's judicial activism, but also to the inherent limitations of the traditional non-discrimination standard. The importance of these errors should not be underestimated: cases of false disparity are harmful to the objective of market integration, while cases of false discrimination wrongfully restrict Member States' tax sovereignty. The final section of this part will be concerned with the question whether the difficulties faced by the ECJ in distinguishing between discrimination and disparities can be resolved by drawing inspiration from the U.S. Supreme Court's case law under the Constitutional Commerce Clause. In that case law, the Supreme Court has developed the so-called 'internal consistency' test, which may prove to be of assistance when deciding whether a measure is due to discrimination or due to a disparity.

Part IV. A comparison of the standards and proposals for improvement

In the final part of this study, the two standards are compared and proposals for improvement are formulated. The divergent interpretation of the standards is traditionally explained and justified by reference to the their different finality. However, the differences are not as vast as generally assumed. The 'European' standard is aimed at abolishing obstacles to interstate trade, thereby furthering the economic development of the internal market. This finality is usually contrasted with the rather limited objective of tax treaties, which are merely intended to avoid double taxation and to prevent tax avoidance. However, this objective of tax treaties is an integral part of a broader underlying finality: the pursuit of the elimination of obstacles to interstate trade in order to advance economic development. And discrimination in tax matters is an example of such an obstacle. Obviously, this finality is very similar to the finality of the European standard. The major difference between both standards lies in the bilateral nature of tax treaties, whereas the European standard is a part of a legal fabric encompassing an entire internal market. This distinction is deceptive as well, since the OECD plainly aspires to create a worldwide network of identical tax treaties, based on the OECD MC and interpreted according to the OECD Commentary.

---

[28] E.g. C-264/96, *ICI*, *ECR* 1998 I-4695, § 23; C-200/98 *X&Y AB*, *ECR* 1999 I-8261, § 28.
[29] E.g. C-336/96, *Gilly*, *ECR* 1998, I-02793.
[30] E.g. C-385/00, *De Groot*, *ECR* 2002, I-11819.
[31] E.g. C-403/03, *Schempp*, *ECR* 2005, I-06421.

Another issue that will be discussed in this final part is the question whether national courts of EU Member States are influenced by the ECJ's case law on the fundamental freedoms when interpreting Article 24. Because Article 24 has a number of important shortcomings, those courts may be tempted to draw inspiration from the European standard. An analysis of case law will reveal whether there is indeed such an influence. Finally, it will be determined whether such an influence is appropriate.

Part II: Article 24 of the OECD Model Convention

1. Origin of Article 24 OECD MC

A. Historical roots of the provision

Throughout history, rulers have tended to impose heavier burdens on foreigners than on nationals[32]. Tax discrimination is but one example of such differentiated treatment. For instance, the French 'droit d'aubaine' was a feudal right of the sovereign to appropriate all the property of a foreigner who died within the realm, to the exclusion of all heirs, whether they were foreigners or nationals. This 'droit d'aubaine' was later replaced by the 'droit de détraction', a tax imposed on the right of a foreigner to acquire by inheritance the property of persons dying within the realm[33].

As international mobility developed, States became increasingly aware of the undesirability of such situations (most likely inspired by motives of self-interest, rather than altruism[34]). Historically, the first stage in the development of regimes aimed at granting foreigners protection from discrimination *vis-à-vis* nationals was the unilateral grant of privileges to foreign merchants by the ruler of a country. At first, the level of protection was defined in general terms, without referring to the treatment of the own nationals[35]. These privileges, which were aimed at stimulating trade, often granted merchants the freedom to trade on markets, the freedom to salvage their wrecked ships and offered them protection and security in general. As these provisions granted a certain level of protection without referring to the treatment of the State's own nationals (see supra, on the constituting elements of discrimination), they cannot be seen as non-discrimination provisions in the strictest sense.

---

[32] Throughout this text, the terms 'foreigner', 'alien' and 'non-national' will be used interchangeably to refer to a person (either a legal person or an individual) who is not a national of the State in question. Similarly, the adjectives 'foreign', 'alien' and 'non-national' will be used interchangeably. When referring to the formal link between a person and a State I will use the term 'national', rather than 'citizen', given the specific meaning of the latter term in several legal systems: citizenship normally refers to the political rights connected with membership of a political community, whereas nationality merely refers to the formal link between a person and a State. It is, for instance, possible to be a national of a State without being a citizen (see e.g. the different classes of nationality in the British Nationality Act 1981).

[33] H.W. HALLECK, *International law or, Rules regulating the intercourse of states in peace and war*, San Francisco, H. H. Bancroft & Company, 1861, 155.

[34] This explains, for instance, the apparent decline in the U.S.'s commitment to tax treaty non-discrimination rules in the past few decades. Until the late 1970's, the amount of inbound foreign direct investment in the U.S. was insignificant as compared to the amount of outbound foreign direct investment. As a result, the U.S. had very little to lose and a lot to gain from including reciprocal non-discrimination agreements in tax treaties. Since then, however, there have been a number of significant surges of foreign direct investment into the U.S., as a result of which the obligations imposed under such non-discrimination provisions have become much more substantial (R. GREEN, "The troubled rule of nondiscrimination in taxing foreign direct investment", 26 *Law and Policy in International Business* 113, 154).

[35] For instance, Henry III (1207-1272), king of England, granted the following privilege to French merchants in 1224: *"Henricus Dei gratia Rex Angliae […] Sciatis quod dedimus & concessimus pacem et securitatem omnibus mercatoribus de potestate Regis Franciae venturis, & moraturis, & recessuris per posse nostrum, & mercandisis ipsorum, a Pascha proximo post obitum Philippi Regis Francorum, usque in 15 dies, a festo sancti Johannis Baptistae proximo sequente; faciendo inde rectas & debitas consuetudines"*, T. RYMER, *Foedera, conventiones, literae, et cujuscunque generis acta publica, inter reges Angliae, et alios quosvis imperatores, reges, pontifices, principes, vel communitates, ab ineunte saeculo duodecimo, viz. ab anno 1101, ad nostra usque tempora, habita aut tractata*, London, A. & J. Churchill, Vol. I, 1704, 265.

However, they proved to be a fundamental first step in the development of non-discrimination clauses in international trade.

As States gradually began dealing with this issue in international agreements, the level of protection shifted towards a treatment on the same footing as nationals[36]. It should be stressed that the principle of non-discrimination was applied in international fiscal relations well before the appearance of the classical type of double taxation conventions at the end of the 19th Century[37]. Clauses to accord non-discriminatory tax treatment to nationals of the other State were thus included in differrent types of international agreements (for instance commerce or navigation treaties[38]). A very early example can be found in the 1535 Treaty of Peace and Alliance between France and the Ottoman Empire:

> *"Item, les dits sujets tributaires des dits Seigneurs pourront respectivement acheter, vendre, changer, conduire et transporter par mer et par terre d'un pays à l'autre, toute sorte de marchandises non prohibées, en payant les coutumes et antiques droits de gabelles ordinaires seulement, à savoir le Turc au pays du Roi comme payent les Français, et les dits Français au pays du Grand-Seigneur comme paient les Turcs, sans qu'ils puissent être constraints à payer aucun autre nouveau tribut, impositions ou angaries, c'est-à-dire corvée."*[39]

Such nationality non-discrimination provisions often existed side by side with most-favoured nation clauses. For instance, the Treaty of Elbing of 1656 between the Netherlands[40] and Sweden introduced a most-favoured nation clause with regard to the payment of taxes, with the reservation that should an increase in taxes become unavoidable, the increased taxes should not exceed those imposed upon the State's own subjects (national treatment)[41]. Other

---

[36] Or, more specifically, a treatment which was not other or more burdensome than the treatment of nationals (cf. infra).

[37] OECD Commentary to Art. 24, para. 2.

[38] E.g. Art. V of the Treaty of Friendship, Commerce and Navigation between the United States and Argentina of 27 July 1853: *"No other or higher duties or charges, on account of tonnage, light or harbor dues, pilotage, salvage in case of average or shipwreck, or any other local charges, shall be imposed in the ports of the two contracting parties on the vessels of the other, than those payable in the same ports on its own vessels"*, W. MALLOY, *Treaties, Conventions, International Acts, Protocols and Agreements Between the United States of America and other powers. 1776-1909*, Washington, U.S. Government Printing Office, 1910, 22.

[39] Art. II of the 1535 Treaty of Peace and Alliance between France and the Ottoman Empire, *Treaties, etc. between Turkey and Foreign Powers. 1535-1855*, London, Foreign Office, 1855, 170.

[40] Which, at the time was called the Republic of the Seven United Netherlands or *Foederatae Belgii Provinciae*.

[41] The national treatment clause read as follows: *"Quod si vero contingat certas ob causas & urgente necessitate nova, majora, gravioraque vectigalia in alterius foederati Dominiis imponenda esse, tum eo casu majus graviusque a foederato aut ejus subditis non exigetur, quam ipsi proprii Incolae aut subditi pendunt."* (*"And if however for certain reasons or urgent necessities it happens that new, higher, or more burdensome taxes are introduced in either contracting State, then* ***no higher nor more burdensome tax*** *will be levied on the other contracting State or on its subjects than is levied on its own residents or subjects"*, my translation, NB) In the Dutch version of the treaty, the clause was: *"Ende by aldien om seekere reden wille, ofte door dringende necessiteyt, quame te gebeuren, datter in 't gebiedt van d'een of d'ander der beyde Geconfoedereerde, vernieuwinge ofte verhoginge van Thollen en belastingen wierde ingevoert, dat in sulcken ghevalle geene hooger nochte swaerder belastingen van d'ander Geconfoedereerde, ofte van syne Onderdanen, sal mogen afgevordert worden, als by de eygene Ingezetenen en Onderdanen van de geene, die de nieuwe ofte verhooghde Thollen ende belastingen mochte komen in te voeren, werden betaelt."*, Tractatus inter Regem Sueciae, ab una, atque Ordines Generales Foederati Belgii, ab altera parte, initus & conclusus Elbingae 1/11 Septemb. 1656 cum illustrationibus Helsingorae 29 novemb./9 decemb. 1659 desuper factis, in J. SCHELTUS, *Recueil van de tractaten, gemaeckt ende geslooten tusschen de hoog mogende heeren Staten Generael der Vereenigde Nederlanden, ter eenre, ende verscheyde koningen, princen ende potentaten, ter ander zyde*, 1726, 's-Gravenhage, 29 (the treaty of 1656 and

early examples include equal tax treatment clauses in bilateral treaties of friendship, commerce and navigation (e.g. Art. 3 of the 1794 Treaty of Amity, Commerce and Navigation between the United States of America and Great Britain[42]). These clauses were aimed at developing and strengthening economic relations between the Contracting States, by according equal tax treatment to investors of one State wishing to pursue industrial or commercial activities in the other State.

The concept of 'direct taxes' (taxes imposed directly on income or property) came into widespread use in the late 18th – early 19th Century. From the very beginning, States imposed such direct taxes on a dual basis: sometimes because of a relationship to the taxpayer (e.g. residence of the State), sometimes because of a relationship to the income or property (e.g. because the property was located in the State's territory). Such a dual basis obviously created the potential for double taxation of the same income or property in the hands of the same taxpayer. At first, this was not a real issue as international trade was quite limited and tax rates were modest. After World War I, however, rates of direct taxation increased significantly and international trade grew rapidly, which meant that double taxation became a worldwide concern[43]. As a result of these evolutions, modern bilateral tax treaties began emerging, which often included non-discrimination provisions.

> The earliest example I could find of a non-discrimination provision in a direct tax treaty is Article 2 of the 1921 treaty between Germany and Czechoslovakia[44], which reads as follows: *"The nationals of either of the two States shall be* ***entitled to equality of treatment with the nationals of the other State*** *so far as taxation is concerned, in the territory of the other State, and more particularly to the same safeguards in their dealings with the revenue authorities, revenue and administrative courts and other tribunals. Legal persons, including companies and also partnerships, institutions, charitable foundations and all other organisations possessing property set aside for a particular purpose, which are not legal persons but which are liable to taxation as such, shall, if they are situated or have their registered office in the territory of one of the two States and if they are legally constituted in accordance with the legislation of the said State, be* ***entitled to the same treatment in matters of taxation*** *in the territory of the other State* ***as that which is accorded to similar taxpayers in the other State****"*.

---

the protocol of 1659 both carry two dates, because at the time, different calendars were in force in both States: part of the provinces forming the Dutch republic had already adopted the Gregorian calendar in the 16th Century, whereas Sweden only gradually changed from the Julian to the Gregorian calendar starting in 1700).

[42] *"All goods and merchandize whose importation into His Majesty's said territories in America, shall not be entirely prohibited, may freely, for the purposes of commerce, be carried into the same in the manner aforesaid by the citizens of the United States, and such goods and merchandize* ***shall be subject to no higher or other duties than would be payable by His Majesty's subjects*** *on the importation of the same from Europe into the said territories. And in like manner, all goods and merchandize whose importation into the United States shall not be wholly prohibited, may freely, for the purposes of commerce, be carried into the same, in the manner aforesaid, by His Majesty's subjects, and such goods and merchandize* ***shall be subject to no higher or other duties than would be payable by the citizens of the United States*** *on the importation of the same in American vessels into the Atlantic ports of the said States"* (emphasis added), Art. 3 Treaty of Amity, Commerce and Navigation signed at London, November 19, 1794 (also known as the Jay Treaty), H. MILLER, *Treaties and other international acts of the United States of America. Documents 1-40 (1776-1818),* Washington, U.S. Government Printing Office, 1931, 247-248.

[43] H. D. ROSENBLOOM and S. I. LANGBEIN, "United States tax treaty policy: an overview", *Columbia Journal of Transnational Law* 1981, 361.

[44] Treaty between Germany and Czechoslovakia for the adjustment of taxation at home and abroad, in particular for the avoidance of double taxation in the field of direct taxation, and concerning legal safeguards and legal assistance in matters of taxation, signed at Prague, December 31, 1921, *League of Nations Treaty Series*, 1923, Vol. XVII, No. 447 (emphasis added).

Actually, this is an equal treatment-clause, rather than a non-discrimination clause[45]. In the Final Protocol to the treaty, the provision is clarified as follows: *"The provisions of Article 2, paragraphs 1 and 2, shall be interpreted as meaning that the taxpayers therein mentioned shall be placed on a footing of equality in respect of taxation, not merely theoretically, but also in practice."*

The earliest example of an actual non-discrimination clause in a direct tax treaty I could find, is the following provision in the 1931 tax treaty between Belgium and Italy: *"§ 1. - As regards the direct taxes to which the present Convention relates, companies and other juristic persons legally constituted in either of the two Contracting States and having their fiscal domicile in its territory, together with their branches and agencies,* ***shall not be subjected*** *in the territory of the other State* ***to higher fiscal charges than those borne by national companies of a like character****.*
§ 2. - The same principle shall apply to natural persons in virtue of Article 5 of the Treaty of Commerce and Navigation concluded between Belgium and Italy on December 11, 1882"[46].

It is remarkable that legal persons are entitled to taxation that is not 'higher' than that of national companies of the like character, while for natural persons, reference is made to a provision in the 1882 Treaty of Commerce and Navigation, which provides as follows: *"Les Italiens en Belgique et les Belges en Italie […]* ***ne pourront être assujettis****, pour leur propriétés mobilières ou immobilières,* ***à d'autres charges, restrictions, taxes ou impôts que ceux auxquels seront soumis les nationaux eux-mêmes****"*[47].

So natural persons should not be subject to 'other' taxation, while legal persons should not be subject to 'higher' taxation. A similar distinction is made in the 1936 treaty between France and Sweden: *"****No distinction*** *shall be made by either State between its own nationals and nationals of the other State for the purposes of application of the rates of the taxes […]. Individuals who are nationals of either State shall be entitled in the other State, subject to the same conditions as nationals of that latter State, to all exemptions, allowances, deductions or reductions of taxes or duties granted on account of family charges. Bodies corporate including companies, as well as associations of persons, institutions, foundations and endowments for specific purposes, without legal personality but subject as such to taxation, if their seat is situated within the territory of either State and their existence is recognized by the law of such State,* ***shall not be liable in the territory of the other State to any higher aggregate taxation*** *than that to which taxpayers of that latter State who are in the same position are liable"*[48]. Accordingly, the distinction here is between nationals, in respect of whom "no distinction" must be made, and bodies corporate with their seat in either State, which "shall not be liable to any higher aggregate taxation".

---

[45] The same provision can also be found in Treaty between Germany and Austria concerning legal safeguards and legal assistance in matters of taxation of 23 May 1922 (*League of Nations Treaty Series* 1924, No. 660, 433). Similar wording is used in Art. 1 of the tax treaty between Germany and the U.S.S.R. of 12 October 1925: *"The nationals of each of the Contracting Parties shall receive in all respects in the territory of the other Party […] rights and interests, particularly as regards […] all matters connected with taxation […]* ***the same treatment and the same protection*** *on the part of the authorities as nationals of the country or nationals of the most favoured nation"* (*League of Nations Treaty Series* 1926, Vol. LIII, No. 1257, 133; emphasis added).
[46] Article I of the Final Protocol to the Convention between Belgium and Italy for the prevention of double taxation and for the settlement of various other questions connected with fiscal matters of 11 July 1931 (*League of Nations Treaty Series* 1933, Vol. CXXXVI, No. 3120, 19).
[47] Traité de Commerce et de Navigation entre la Belgique et l'Italie de 11 Décembre 1882, *British and Foreign State Papers* 1881-1882, Vol. 73, 597 (emphasis added).
[48] Point XIV of the Protocol to Convention between the French Republic and Sweden for the avoidance of double taxation and the establishment of rules of reciprocal administrative assistance with respect to direct taxes of 24 December 1936 (emphasis added).

As a final early example, see point 12 of the Protocol to the 1942 Canadian/U.S. treaty: *"The citizens of one of the Contracting States residing within the other Contracting State shall not be subjected to the payment of more burdensome taxes than the citizens of such other State."*

B. The League of Nations

Pursuant to the Treaty of Versailles, the League of Nations was created in 1920 *"in order to promote international co-operation and to achieve international peace and security"*[49]. In 1921, the Financial Committee of the League of Nations, which was entrusted with the study of double taxation, asked four experts to draw up a report dealing with certain issues of double taxation[50]. A general report was prepared, followed by four model conventions[51]. These conventions did not include a provision on tax discrimination.

The model conventions were later revised by the newly established Fiscal Committee of the League of Nations. This work resulted in two draft treaties on the prevention of double taxation of income and property[52]: the Mexico Draft of 1943 and the London Draft of 1946. These drafts were the first League of Nations model conventions to contain a clause dealing with tax discrimination. The clause, which was identical in both drafts, read as follows:

> *A taxpayer having his fiscal domicile in one of the contracting States shall not be subject in the other contracting State, in respect of income he derives from that State, to higher or other taxes than the taxes applicable in respect of the same income to a taxpayer having his fiscal domicile in the latter State, or having the nationality of that State*[53].

The Commentary to these drafts indicated that this clause was intended to prevent discriminatory treatment in one country of taxpayers having their 'fiscal domicile' in the other country, whether or not they were nationals of that country. Therefore, States were prohibited from subjecting such taxpayers to higher or other taxes than those applicable in respect of the same income to a taxpayer having his fiscal domicile in the latter State, or having the nationality of that State. It is also indicated that the provision applied to 'taxes on property, capital or increment of wealth' as well, even though this is not expressly stipulated in the clause[54]. The term 'fiscal domicile' was defined as: *"In the case of an individual or an*

---

[49] Preamble to the Covenant of the League of Nations, signed in Paris on 28 June 1919, and entered into force on 10 January 1920.
[50] "League of Nations Economic and Financial Commission. Report on Double Taxation submitted to the Financial Committee, April 1923", *Legislative History of United States Tax Conventions*, vol. 4, 1962, 4006.
[51] One on direct taxes, one on succession duties, one on administrative assitance in matters of taxation and one on assistance in the collection of taxes: "League of Nations. Double Taxation and Tax Evasion. Report presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion, October 1928", *Legislative History of United States Tax Conventions*, vol. 4, 1962, 4151.
[52] Four other drafts were published as well: two on the prevention of double taxation on estates and successions, and two on the reciprocal administrative assistance for the assessment and collection of taxes on income, property, estates and successions. Those drafts will not be discussed here.
[53] Art. XV of the Mexico Draft, "League of Nations Fiscal Committee. London and Mexico Tax Conventions. Commentary and Text", *Legislative History of United States Tax Conventions*, vol. 4, 1962, 4388; Art. XVI of the London Draft, *o.c.*, 4389.
[54] *Ibid.*, 4351.

enterprise belonging to an individual, the place where the individual has his normal residence, the term 'residence' being understood to mean permanent home"[55].

With regard to the domicile of legal entities, the drafts are worded differently. The Mexico draft states: *"The fiscal domicile of partnerships, companies and other legal entities or de facto bodies shall be the State under the laws of which they were constituted"*[56].

The London Draft, by contrast, defines the residence of such entities as follows: *"The fiscal domicile of a partnership, company and any other legal entity or de facto body shall be the State in which its real centre of management is situated"*[57].

Thus, the League of Nations non-discrimination provision was very broad, protecting non-residents from any 'higher or other' taxes than those applicable to residents or nationals of the State concerned, without including any reservations to limit the scope of application.

After the second World War, the League of Nations was replaced by the United Nations[58]. The UN Fiscal Committee was created in order to continue the work of the League of Nations Fiscal Committee, but no real progress was made[59].

C. The OEEC Fiscal Committee

I. The first report of Working Party no. 4

The early work of the OEEC Fiscal Committee was already concerned with the issue of tax discrimination[60]. The Council Resolution of 19 March 1956 creating a Fiscal Committee states that, *"a new Committee, to be known as the 'Fiscal Committee', is hereby established for the study of questions relating to double taxation and of other fiscal questions of a similar technical nature"*. One of the questions to be studied by the Committee was *"the means of*

[55] Art. II (1) of the Protocol to the Convention, *o.c.*, 4392-4393. Art. II (2) and (3) contained the following tie-breaker rules: *"Should a taxpayer possess a residence in both the contracting States, the competent administration shall determine, by common agreement, the place of his main residence, which shall be considered as his fiscal domicile. In order to determine, as between several residences, the main residence, the competent administration will take into account elements such as the duration, regularity, frequency of stays, the place where the family of the taxpayer is usually present, the proximity to the place where the party concerned carries out his occupation. […] In the case of a taxpayer having a residence in both of the contracting States of which either can be considered as his main residence, Article XVII [Article XIX in the London Draft] of the Convention shall apply."* Art. XVII / XIX holds that, in such a case, the competent authorities of the two contracting States shall confer together and take the measures required in accordance with the spirit of the Convention.

[56] Art. II (4) of the Protocol to the Convention (Mexico Draft), *o.c.*, 4392.

[57] Art. II (4) of the Protocol to the Convention (London Draft), *o.c.*, 4393.

[58] Charter of the United Nations, signed in San Francisco on 26 June 1945, and entered into force on 24 October 1945.

[59] A. VAN DEN TEMPEL, *Relief from double taxation. A comparison of the work of the League of Nations and of the Organisation for Economic Cooperation and Development*, Amsterdam, IBFD Publications, 1967, 9.

[60] The Organisation for European Economic Cooperation was created in 1948 by the Convention for European Economic Cooperation, signed in Paris on 16 April 1948, and entered into force on 1 July 1948, *International Organization* 1948, vol. 2, no. 2, 420. Its original purpose was the management of the American aid in the context of the Marshall Plan, thereby cooperating in order to ensure European recovery from the economic consequences of WWII.

removal of inequalities in taxation on grounds of nationality"[61]. Thus, in the list of studies to be undertaken first by the Fiscal Committee, reference is made to the *"study of the inequalities in taxation on grounds of nationality"*[62]. However, when the list of Working Parties was compiled, the wording was changed to *"the study of discrimination in taxation on grounds of nationality or on similar grounds"*[63]. It is not entirely clear why the wording was changed overnight, and whether this change carries much weight. In any event, it is interesting to note this changeover in the light of the subtle difference between the principle of equality and the principle of non-discrimination (see infra).

The first report of Working Party no. 4 was mainly concerned with nationality discrimination[64]. Some interesting general remarks were made in the report. For instance, in none of the OEEC Member States who filled out the questionnaire[65] was liability to tax made dependent on a person's nationality. However, the tax assessment was found to be influenced by the taxpayer's nationality in certain cases. For instance, some Member States only gave certain tax reliefs to their own nationals. Furthermore, one Member State granted more favourable tax treatment to foreigners than to its own nationals (reverse discrimination, see infra). The issue of reverse discrimination was not included in the Working Party's study, because it was thought that a Member State *"is able to decide of its own accord to end the discrimination against its own nationals"*[66].

Another issue which was omitted from the study was the possibility that Member States would accord favourable treatment to nationals of one State, without extending such treatment to nationals of other States. The Working Party held that *"such tax discrimination on grounds of nationality – which can be eliminated merely by incorporation of the most favoured nation clause – is based on very special economic, financial or political relations and interests*

---

[61] Resolution of the Council of 19 March 1956, C(56)49(Final), 2. The same wording (i.e. *"the removal of inequalities in taxation on grounds of nationality"*) was used earlier in a proposal by the Dutch, Swiss and German delegations concerning questions to be discussed by the group of taxation experts to be set up within the OEEC: *"In a resolution of 2nd July 1954, the International Chamber of Commerce proposed to the OEEC that it should recommend its Member countries to conclude bilateral agreements for the avoidance of double taxation and to adopt unilateral measures with the same object. To give effect to this suggestion, the Executive Committee instructed the Secretary-General to prepare proposals as to what fiscal problems (particularly those relating to double taxation) might profitably be studied by a group of experts of the OEEC To facilitate the Secretariat's task, the Netherlands, Swiss and German Delegations put forward the following suggestions: […] to study, in the OEEC and within a group of taxation experts, the Double Taxation Agreements entered into by the Member countries of the OEEC with respect to taxes on income, capital and estates of deceased persons and, as far as possible, to endeavour to adjust these Agreements one to another. […] The group of taxation experts might profitably discuss the following questions: […] Study of the main provisions of the Double Taxation Agreements entered into by the Member countries of the OEEC, so as to determine how far it would be possible and desirable to adapt them one to another and, more particularly, to standardise their essential concepts. In the opinion of the three delegations such a study should primarily cover the following main points: […] (h) the removal of inequalities in taxation treatment on grounds of nationality (not specifically a double taxation matter)"*, Double taxation memorandum by the delegations for the Netherlands, Switzerland and Germany of 9 December 1955, C(55)307, 2-3.

[62] Fiscal Committee. List of studies to be undertaken first, 23 May 1956, TFD/DI/30, 1.

[63] Fiscal Committee. List of Working Parties, 24 May 1956, TFD/FC/2, 1.

[64] Working party no. 4 of the fiscal committee (Netherlands - France). Report on tax discrimination on grounds of nationality or similar grounds, 11 January 1957, FC/WP4 (57)1.

[65] I.e. Austria, Belgium, France, Germany, Ireland, Italy, Luxemburg, the Netherlands, Sweden, Switzerland, Turkey and the United Kingdom.

[66] FC/WP4 (57)1, 2.

between the two contracting parties which are not to be found vis-à-vis other Member countries or, if they are, are not of the same degree"[67].

As a general finding, the report indicated that actual tax discrimination on the basis of nationality only occurred exceptionally. As most tax legislations placed all taxpayers having their residence in the Member State on the same footing, nationality was only rarely used as a distuingishing factor. The exceptions consisted mainly in giving larger personal reliefs for family circumstances, etc. to nationals of the Member State concerned than to nationals of other States. Reference was also made to the tax regime in the Netherlands, under which resident foreigners were unable to invoke the internal measures for double taxation relief, unless they maintained their residence in the Netherlands for at least 3 years or unless the State whose nationality they possessed extended reciprocal treatment. Resident nationals of the Netherlands were able to claim relief without exception. This was found to be a clear case of nationality discrimination[68].

The Working Party concluded that the OEEC Member States *"acknowledge in general the importance of eliminating the few cases of discrimination that still exist between them and of giving formal recognition, through the medium of Conventions, to the principle of non-discrimination on grounds of nationality."* Further, the Working Party proposed the following common viewpoint to be adopted by the Fiscal Committee:

> *(1) The nationals of a Member country of the OEEC*[69] *shall not be subjected in the territory of any other Member country to any taxation or any requirement connected therewith, with respect to taxes on income, on capital, on estates and inheritances and on gifts, which is other, higher or more burdensome than the taxation and connected requirements to which the nationals of the latter country are or may be subjected.*
>
> *(2) The term 'nationals' means:*
> *(a) all individuals possessing the nationality of a Member country of the OEEC;*
> *(b) all legal persons, partnerships and associations deriving their status as such from the law in force in any Member country of the OEEC.*

The text was based on a provision found in the existing tax treaties concluded between the U.K. and most of the countries represented in the Fiscal Committee[70] [71]. The Working Party

---

[67] FC/WP4 (57)1, 2. This statement may offer support for the position that the non-discrimination provision of Art. 24 OECD MC does not contain an implicit most favoured nation-clause; see infra, 2.A.

[68] FC/WP4 (57)1, 2. Another examples given in the report was the taxation on a 'remittance basis' in the U.K. and Ireland.

[69] It is interesting that this provision refers to "the nationals of **a** Member country of the OEEC". Similarly, the definition of nationality in paragraph 2 refers to "the nationality of **a** Member country of the OEEC" and "the law in force in **any** Member country of the OEEC". Including such provisions in a bilateral treaty would prevent a contracting State from discriminating against nationals of **any** OEEC country. AVERY JONES points out that this remarkable approach should be seen in the context of the original intention to include the non-discrimination provision in a multilateral treaty (J. AVERY JONES, "Understanding the OECD Model Tax Convention: the lesson of history", *Florida Tax Review* 2009, 30-31). As will be pointed out below, later versions of the non-discrimination clause refer to "the nationals of a contracting State", "the nationality of one of the contracting States" and "the law in force in one of the contracting States".

[70] E.g. Art. XVIII of the treaty between the U.K. and the Netherlands (concluded 15 October 1948) and Art. XVII of the treaty between the U.K. and Germany (concluded 18 August 1954), both of which read: *"The nationals of one of the Contracting Parties shall not be subjected in the territory of the other Contracting Party*

immediately pointed out that the proposed provision was *"already covered – so far as individuals are concerned – by Article 21, par. 1, of the European Convention on Establishment*[72]*."* In this Article 21(1), it was expressly stated that the non-discriminatory treatment only applied to the respective nationals who are **in similar circumstances**. The Working Party, however, considered that it was *"not necessary to lay down separately the condition essential to the provision in question, namely, that similar circumstances must exist; rather does it consider that such a condition is already implied in the first paragraph of the proposed text"*[73].

Attention was also drawn to the issue of statelessness. The Working Party first referred to the 1954 Convention of New York (see infra, 2.C.I) and proposed to the Committee to add the following paragraph to the text on nationality quoted above:

> *(3) Stateless persons shall not be subjected in the territory of any Member country to any taxation or any requirement connected therewith, with respect to taxes on income, on capital, on estates and inheritances and on gifts, which is other, higher, or more burdensome than the taxation and connected requirements to which the nationals of that country are of may be subjected.*

The final section of the report dealt briefly with discrimination based on 'the situs of an enterprise'. Questions concerning discriminatory treatment resulting from differences in domicile[74] were considered to elude the Working Party's scope of action: *"It is not within the intentions of the Working Party to judge, in every case which can arise, whether and to what extent differences in treatment between persons domiciled and persons not domiciled in the territory of member countries of the OEEC should be eliminated."*

One exception was made, however, with regard to the computation of profits realised through a permanent establishment: *"The question arises whether the profits of such a permanent establishment, considered as an enterprise established in the State in which it has its situs, should be computed differently from the profits of a national enterprise of that State, solely on the grounds that the operator has his fiscal domicile out of that State."* The Working Party suggested an answer in the negative, thereby referring to a provision included in a number of

---

to any taxation or any requirement connected therewith which is other, higher, or more burdensome than the taxation and connected requirements to which the nationals of the latter Party are or may be subjected." Obviously, the League of Nations Drafts (cf. supra) were a source of inspiration as well. For a comparison between the OECD draft and the League of Nations Drafts, see A. VAN DEN TEMPEL, *o.c.*, 25 *et seq.*

[71] In this regard, the Working Party made the following remark: *"In these Conventions, the expression 'taxes' has a wider sense than the taxes considered by the Working Party in its study. It is pointed out that this text does not apply only to taxes imposed by the State, but also to taxes imposed by the political subdivisions of a State"*, FC/WP4 (57)1, 4.

[72] Art. 21 (1) of the European Convention on Establishment, Paris 13 December 1955, *U.N.T.S.* Vol. 529, 141 reads as follows: *"Subject to the provisions concerning double taxation contained in agreements already concluded or to be concluded, nationals of any Contracting Party shall not be liable in the territory of any other Party to duties, charges, taxes or contributions, of any description whatsoever, other, higher or more burdensome than those imposed on nationals of the latter Party in similar circumstances; in particular, they shall be entitled to deductions or exemptions from taxes or charges and to all allowances, including allowances for dependants"*.

[73] *Ibid.* See also infra, 2.B.V, on the expression 'in the same circumstances'.

[74] The report uses the term 'domicile', which has its origins in common law and which is sometimes used as an alternative to 'residence'. However, both terms do not overlap entirely. I will therefore avoid the use of the term 'domicile', and use 'residence' instead.

existing tax treaties at the time[75]. The Working Party formulated its views on the issue as follows: *"profits which an operator domiciled or established in a Member country of the OEEC obtains in some other Member country of the OEEC through a permanent establishment situated therein shall not be less favourably computed by the latter Member country than similar profits obtained by an operator established or domiciled in its own territory"*[76].

II. Reception of the first report

Following the first report, the Belgian, Swedish and Swiss delegations sent written remarks to the Working Party, which made several observations thereupon[77]. For instance, the Belgian delegation had proposed that the wording of the first paragraph of the draft Article should be simplified by substituting, the words *"any taxation or any requirement connected therewith […] which is other, higher or more burdensome"*, with the words *"any taxation or any requirement connected therewith […] which is more burdensome"*. The Working Party considered that such an amendment would leave room for conflicting judgments on the question whether any given taxation is more burdensome or not than some other taxation. According to the Working Party, a better way of simplifying the text would be to merely prohibit a State from imposing *"taxation which is other"* than the taxation imposed on its own nationals[78]. Ultimately, a compromise was reached on *"taxation or any requirement connected therewith which is other or more burdensome"*.[79]

Furthermore, the Belgian and Swiss delegations proposed that in the first paragraph of the draft Article the words *"in identical/similar circumstances"* should be inserted after the words *"the latter country"*. However, the Working Party was still of the opinion that *"such an addition is unnecessary, and that it is obvious that the text suggested could not imply the extension to foreign nationals of the treatment appropriate to the country's own nationals whose tax circumstances were different."* Nevertheless, the Working Party agreed to the proposed addition, but worded it as *"in the like circumstances"*[80].

The Belgian delegation also criticized the proposed provision on permanent establishments, and suggested the removal of that provision. The Belgian delegation argued that the existence of special rules in a State's tax system on the computation of profits acquired through PEs of

---

[75] The provision read as follows: *"an enterprise carried on by a person domiciled in the territory of one of the two contracting States is not to be subjected in the territory of the other State, in respect of the profits (and of the capital) of a permanent establishment maintained by it in that other State, to tax which is other or more burdensome than that to which enterprises carried on by persons domiciled in the territory of the latter State are subjected"*

[76] FC/WP4 (57)1, 7. See also infra, 2.D, on the current Art. 24(3) OECD MC, which deals with permanent establishments.

[77] Working party no. 4 of the fiscal committee (Netherlands - France). Supplementary report on tax discrimination on grounds of nationality or similar grounds, 10 May 1957, FC/WP4 (57)2.

[78] FC/WP4 (57)2, 2.

[79] FC/WP4 (57)3, 3. The expression 'other or more burdensome' was first used in the 1945 U.K./U.S. treaty. See also infra, 2.B.VI.

[80] FC/WP4 (57)2, 2. It is not clear why the expression 'in the like circumstances' is used instead of 'identical' or 'similar'. In any event, that term is not used in the nationality non-discrimination clauses of the early U.K. treaties on which the text was based. As of the third report, the wording was changed to "in the same circumstances" (FC/WP4 (57)4, 4).

foreign enterprises may be justified on several grounds[81]. The Working Party disagreed, and noted the close connection between the proposed provision and the PE clause to be found in most tax treaties (i.e. that the profits of a PE of a foreign enterprise must be computed as if the PE was an independent enterprise). If an enterprise wishes to invoke the PE non-discrimination provision, it must, in respect of its PE, comply with the rules prescribed for conducting a national enterprise. For instance, the PE's accounts will have to be kept in the same way as a national enterprise's accounts. Thus, the provision would leave States completely free to devise special rules for computing the profits of a PE of a foreign enterprise, as long as such profits are not less favourably computed than the profits of national enterprises.

The Swiss delegation proposed to insert a non-discrimination clause in respect of foreign ownership, worded as follows:

> *The income, profits and capital of an enterprise of one of the States, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more persons domiciled in the other State, shall not be subjected in the first-mentioned State to any taxation which is other, higher or more burdensome than the taxation to which other similar enterprises of that first-mentioned State in the like circumstances are or may be subjected in respect of the like income, profits and capital.*

The Working Party noted that the discrimination in question arose only very rarely in the OEEC Member countries but it nevertheless agreed to include the provision, albeit in a slightly modified form:

> *The income, profits and capital of an enterprise established in a Member country of the OEEC, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more persons domiciled in some other Member country, shall not be subjected in the first-mentioned country to any taxation which is other, higher or more burdensome than the taxation to which other similar enterprises in the like circumstances established in that first-mentioned country are or may be subjected in respect of the like income, profits and capital*[82].

---

[81] FC/WP4 (57)2, 5:*"Firstly, a foreign enterprise cannot be subjected to such full inspection as a national enterprise. From this point of view, the Belgian Delegation considers that the application of such special provisions should only be dispensed with in relations between countries bound to each other by Conventions for the avoidance of double taxation and the establishment of mutual administrative assistance with respect to taxation. Secondly, such special provisions can also be of advantage to the foreign enterprise, since in having to comply with them in computing its profits it can be relieved of the obligation to compute its profits on the basis of detailed accounts which it would find it costly to maintain."* It is quite possible that the Belgian delegation objected against the inclusion of a PE non-discrimination clause because the Belgian tax legislation at the time allowed the Belgian tax authorities, in the absence of evidence provided either by the taxpayer or by the tax authorities, to tax foreign businesses operating in Belgium on the basis of a minimum tax base (Article 28 of the 1920 Tax Code, as introduced by the Law of 3 August 1920). That regime was later considered discriminatory by the ECJ in *Talotta* because, in the case of residents, the tax authorities could also apply other methods to determine the taxable profits (see Part III, 2.E.I.A.b.8.a). For an analysis under Article 24(3) OECD MC, see Part II, 2.D.III.C.a.1.

[82] FC/WP4 (57)2, 8 and 10. Once again, the wording of the provision seems to have been inspired by the U.K. treaties in force at the time (see e.g. Art. XIX(3) of the 1951 treaty with Norway, Art. XVI(3) of the 1953 treaty with Greece and Art. XVIII(3) of the 1954 treaty with Switzerland). As in the first paragraph, it is not clear why the expression "in the like circumstances" is used. It is interesting to note, in any event, that the text suggested by

III. The second report

In September 1957, a second supplementary report was published[83]. That report consisted mainly of a summary of the proceedings so far, and several examples to clarify certain issues. Furthermore, the foreign ownership clause and the PE clause were amended, and a sixth paragraph was added:

> *(4) The taxation on a permanent establishment which an operator domiciled or established in the territory of one of the Contracting Parties owns in the territory of another Contracting Party shall not be less favourably assessed by that other Contracting Party than in the case of an operator domiciled or established in its own territory and engaged in the like business.*
>
> *(5) An enterprise established in the territory of one of the Contracting Parties, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more persons domiciled in the territory of another Contracting Party, shall not be subjected in the territory of the first mentioned Contracting Party to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which (other)[84] similar enterprises in the like circumstances established in the territory of the first-mentioned Contracting Party are or may be subjected.*
>
> *(6) In this Article the term 'taxation' means contributions of every kind and description levied by any authority whatsoever.*

IV. The third report

About two months later, the Working Party was asked to draft a new version of the proposed Article, as two amendments were suggested to the paragraph on PEs[85]. First, it was proposed to refer to the enterprise's nationality, rather than to its residence. However, the Working Party repeated its position that the nationality of the enterprise is of no importance to the PE non-discrimination clause. As the introduction of nationality in the provision would severely

---

the Swiss delegation (see supra) also referred to "in the like circumstances", while Article XVIII(3) of the 1954 Switzerland/U.K. treaty referred to "other like enterprises [...] in similar circumstances". As of the third report, the wording in the draft was changed to "in the same circumstances" (FC/WP4 (57)4, 4). Interestingly, the French version of the Swiss proposal used the expression "les entreprises de cet autre Etat exploitées de manière semblable". In contrast, the provision proposed by the Working Group used the expression "d'autres entreprises semblables établies dans le territoire de la première Partie Contractante et se trouvant dans la même situation". In the second report, the term "d'autres" was replaced by "les" (see hereafter).

[83] Working party no. 4 of the fiscal committee (Netherlands - France). Second supplementary report on tax discrimination on grounds of nationality or similar grounds, 13 September 1957, FC/WP4 (57)3.

[84] In the original OEEC document, the word 'other' is put between handwritten brackets. The reason for those brackets seems to be that, in the French version, the text was originally: *"[...] ne sera soumise dans le territoire de la première Partie Contractante à aucune imposition ou obligation y relative, qui serait autre ou plus lourde que celle à laquelle sont ou pourront être assujetties* ***d'autres*** *entreprises semblables établies dans le territoire de la première Partie Contractante et se trouvant dans la même situation"* (emphasis added). However, the expression 'd'autres' was crossed out in handwriting and changed to 'les'.

[85] Working party no. 4 of the fiscal committee (Netherlands - France). Third supplementary report on tax discrimination on grounds of nationality or similar grounds, 7 November 1957, FC/WP4 (57)4.

limit its scope of application, the Working Party suggested that the proposed amendment should not be carried out[86]. The second proposed amendment concerned the application of personal allowances, reliefs and reductions granted on account of civil status and family responsibilities. The Working Party agreed that an amendment in this respect should be introduced and proposed the following wording:

> *This provision shall not be construed as obliging any contracting party to grant to individuals residing in the territory of any other contracting party any personal allowances, reliefs and reductions for tax purposes on account of civil status or family responsibilities which it grants to individuals residing in its own territory.*

Finally, this third report changed the last words of para. 5 to *"which is other or more burdensome than the taxation and connected requirements to which are or may be subjected similar enterprises established in the territory of the first-mentioned contracting party which are in the same circumstances."*

V. The final report

In February 1958, the Working Party issued a final report, containing the draft Article and an accompanying Commentary[87]. The draft Article read as follows:

(1) The nationals of any Contracting Party shall not be subjected in the territory of any other Contracting Party to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which are or may be subjected the nationals of that other Contracting Party who are in the same circumstances.

(2) The term 'nationals' means:

(a) all individuals possessing the nationality of one of the Contracting Parties
(b) all legal persons, all partnerships and associations deriving their status as such from the law in force in one of the Contracting Parties.

(3) Stateless persons shall not be subjected in the territory of any Contracting Party to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which are or may be subjected the nationals of that Contracting Party who are in the same circumstances.

(4) The taxation levied by any Contracting Party on permanent establishments situated in the territory of that Contracting Party and owned by an entrepreneur domiciled or established in the territory of any other Contracting Party shall not be less favourable than that levied on an entrepreneur domiciled or established in its own territory and carrying on the same activities. This provision shall not be construed as obliging any Contracting Party to grant to individuals residing in the territory of any other Contracting Party any personal allowances,

[86] FC/WP4 (57)4, 2-3.
[87] Working party no. 4 of the fiscal committee (Netherlands - France). Final report on tax discrimination on grounds of nationality or similar grounds, 19 February 1958, FC/WP4 (58)1.

reliefs and reductions for tax purposes on account of civil status or family responsibilities which it grants to individuals residing in its own territory.

(5) An enterprise established in the territory of any Contracting Party, the capital of which is wholly or partly owned of controlled, directly or indirectly, by a person or persons domiciled in the territory of any other Contracting Party shall not be subjected in the territory of the first-mentioned Contracting Party to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which are or may be subjected similar enterprises established in the territory of the first-mentioned Contracting Party[88].

(6) In this Article the term 'taxation' means taxes of every kind and description levied by any authority whatsoever.

Thus, when the final report was completed, there had been no debate on the possibility of including a deductibility non-discrimination provision (the current Art. 24(4) OECD MC, cf. infra). This issue was first discussed in the context of allocation rules with regard to interest and royalties[89]. The issue was also addressed in the Comm. OECD 1963 on Art. 11[90] and 12[91], but not in the non-discrimination provision of the OECD MC 1963. Only in 1977, when the current Art. 24(4) OECD MC was included in the text of the MC was this issue addressed in the non-discrimination provision.

In 1958, the OEEC Fiscal Committee presented its first report on the elimination of double taxation to the Council[92]. In this report, the Committee admits that the question of tax discrimination *"has no connection with problems of double taxation"*, but indicates that it has been included in several existing tax treaties, commercial conventions, the 1954 Convention of New York on stateless persons, etc. According to the Committee, the proposed draft Article on discrimination *"contains a provision on reciprocal taxation treatment of nationals. Although tax discrimination on grounds of nationality is an exception in the Member countries of the OEEC, nevertheless it is important that Member countries' adhesion to the principle of no discrimination for nationality reasons should be clearly embodied in the texts of their double taxation Conventions in view, particularly, of the force of example that this can have for their relations with third countries"*. Furthermore, the proposed PE non-discrimination clause, *"which is found less frequently in the existing Conventions than the provision on reciprocal taxation treatment of nationals, will give firms greater security in expanding their international business"*[93].

[88] The report clarified that the words 'which are in the same circumstances' at the end of para. 5 had been deleted for two reasons: *"first, they might lead to misunderstanding; secondly, they add nothing to the meaning of the provision, the purpose of which is to subject enterprises situated in a given State and under foreign control to the same treatment as similar enterprises likewise established in the same State"*, FC/WP4 (58)1, 4.
[89] Cf. for instance the minutes of the 20th Session of the Fiscal Committee of the OEEC, 6-9 September 1960, FC/M(60)5, 9-10 (discrimination with regard to the deductibility of royalties).
[90] Comm. OECD 1963 to Art. 11, para. 17.
[91] Comm. OECD 1963 to Art. 12, para. 9.
[92] First Report of the Fiscal Committee of the OEEC on the elimination of double taxation, September 1958, *Legislative History of United States Tax Conventions*, vol. 4, 1962, 4445.
[93] First Report of the Fiscal Committee of the OEEC on the elimination of double taxation, September 1958, *Legislative History of United States Tax Conventions*, vol. 4, 1962, 4465. The proposed Article is identical to the Article included in the 1963 Draft Convention, except for the title (the 1958 Draft was entitled "Tax discrimination on grounds of nationality or other similar grounds").

VI. Conclusions

The text of the current non-discrimination provision in the OECD MC (see infra) is, for the most part, identical to the text proposed by the OEEC Working Party. For that reason, it is interesting to consider why the Working Party drafted the provision the way it did. As a first point, it is noteworthy that the Working Party had little regard for the practical applicability of the proposed provision. For instance, the paragraph on nationality discrimination was included even though the Working Party acknowledged that nationality discrimination was very rare in practice. Moreover, it does not seem that the Working Party had a general, overarching idea in mind to bind the different paragraphs together. Rather, new paragraphs were included or amendments were made following suggestions of the different delegations. This has resulted in an amalgam of isolated obligations, a provision that covers a number of discrete issues, without there being a clear underlying concept that unites the paragraphs.

Another interesting point is that the Working Party does not address the purpose of the provision extensively. The most significant reference to the purpose of Art. 24 is the following statement made in the context of the PE non-discrimination clause*: "the value of the provision, **as indeed of the Article as a whole**, is this, that the Member countries of the OEEC, by their formal adherence to the principle of non-discrimination will help to propagate this principle which is so vital for the development of international economic relations"*[94].

In other words, non-discrimination was seen as a tool for the development of international economic relations. By formally adhering to that principle, OEEC Member States would "help to propagate" this principle. It is interesting, in this respect, that the Working Party generally considered that the inclusion of a non-discrimination clause in tax treaties would have no significant impact on the tax laws of the OEEC Member States, simply because it was thought that tax discrimination was very rare in those Member States.

For instance, when the Swiss Delegation proposed to insert a foreign ownership non-discrimination clause, the Working Party stated: *"It would appear that the discrimination in question arises only very rarely in the Member countries of the OEEC. The Working Party therefore considers that the Member countries will find it easy to accept the proposed provision. Nevertheless, such a provision will be of the fullest importance in relations with countries which see no objection in applying such discrimination."*[95]. Instead, the formal commitment to the principle by including it in tax treaties was mainly seen as having an influence on third States.

[94] FC/WP4(57) 2, 6 (emphasis added).

[95] FC/WP4(57) 2, 8. See also, for instance, FC/WP4(57) 2, 6, with respect to the PE non-discrimination clause: *"The replies to the questionnaire which [the Working Party] circulated have shown beyond doubt that the form of discrimination in question here occurs but very rarely in the Member countries of the O.E.E.C."* Similarly, FC/WP4(57) 1, 2, with respect to the nationality non-discrimination clause: *"The replies to the questionnaire indicate that this form of discrimination occurs only exceptionally."* As a final example, consider the following statement in the final report, quoted above: *"Although tax discrimination on grounds of nationality is an exception in the Member countries of the OEEC, nevertheless it is important that Member countries' adhesion to the principle of no discrimination for nationality reasons should be clearly embodied in the texts of their double taxation Conventions* ***in view, particularly, of the force of example that this can have for their relations with third countries****"* (emphasis added).

As will become apparent below, the principle of non-discrimination as embodied in the provisions of Art. 24 would have a more significant impact on the tax law systems of the OEEC (later: OECD) Member States than originally anticipated.

D. The genesis of the OECD MC

When first published in 1963, the OECD Model Convention[96] contained a non-discrimination provision in Article 24. In the subsequent revisions of the Model, Article 24 has been slightly changed in some regards, but the basic approach has always remained the same. Hereafter, the different incarnations of Article 24 OECD MC will be compared.

In the 1963 Draft Convention, Article 24 reads as follows:

1. The nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected.

2. The term 'nationals' means:

a) all individuals possessing the nationality of a Contracting State;

b) all legal persons, partnerships and associations deriving their status as such from the law in force in a Contracting State.

3. Stateless persons shall not be subjected in a Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that State in the same circumstances are or may be subjected.

4. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.

This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of that first-mentioned State are or may be subjected.

6. In this Article the term 'taxation' means taxes of every kind and description.

[96] *Draft Double Taxation Convention on Income and capital*, OECD, Paris, 1963.

Several changes were brought about in the 1977 Model. Deletions are indicated in ~~strikethrough~~, additions are placed [between brackets].

1. ~~The~~ nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith[,] which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. [This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States.]

2. The term 'nationals' means:

a) all individuals possessing the nationality of a Contracting State;

b) all legal persons, partnerships and associations deriving their status as such from the law in force in a Contracting State.

3. Stateless persons [who are residents of a Contracting State] shall not be subjected in ~~a~~ [either] Contracting State to any taxation or any requirement connected therewith[,] which is other or more burdensome than the taxation and connected requirements to which nationals of ~~that~~ [the] State [concerned] in the same circumstances are or may be subjected.

4. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. ~~¶¶~~ This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

[5. Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12, apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.]

~~5~~[6]. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned ~~Contracting~~ State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of ~~that~~ [the] first-mentioned State are or may be subjected.

~~6~~[7]. ~~In this Article the term 'taxation' means~~ [The provisions of this Article shall, notwithstanding the provisions of Article 2, apply to] taxes of every kind and description.

Finally, the 1992 Model and the successive amendments of 1997 brought about the following changes[97]:

[97] The amendments made in 1994, 1995, 2000 and 2003 left Article 24 unaffected

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances[, in particular with respect to residence,] are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States.

~~2. The term 'nationals' means:~~

> *~~a) all individuals possessing the nationality of a Contracting State;~~*
> *~~b) all legal persons, partnerships and associations deriving their status as such from the law in force in a Contracting State.~~*[98]

~~3~~*[2]. Stateless persons who are residents of a Contracting State shall not be subjected in either Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of the State concerned in the same circumstances[, in particular with respect to residence,]*[99] *are or may be subjected.*

~~4~~*[3]. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.*

~~5~~*[4]. Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12, apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.*

~~6~~*[5]. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.*

~~7~~*[6]. The provisions of this Article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind and description.*

---

[98] This provision has been moved to Art. 3, para. 1, (g). It has since been amended to read as follows:
i) any individual possessing the nationality [or citizenship] of that Contracting State; and
(ii) any legal person, partnership or association deriving its status as such from the laws in force in that Contracting State
[99] 1997 addition

2. The current version of Article 24 OECD MC

A. General remarks

Throughout the evolution of the OECD Model Convention, the non-discrimination provision has remained fundamentally unchanged. The most important changes have arguably been the 1977 addition of the deductibility provision and the 1992 addition of the expression "in particular with respect to residence" in Art. 24(1). The reasons for the latter addition will be addressed below, where the different paragraphs of Art. 24 will be studied seperately. It should be mentioned that paragraph 1 and 2 of Art. 24 take nationality as the reference point in determining whether discrimination exists, whereas paragraph 3, 4 and 5 refer to residence. The reasons for this dichotomy will be addressed below.

> Even though the value of non-discrimination provisions in tax treaties is widely accepted, some States are reluctant to include such provisions in their tax treaties. Australia, for instance, generally does not adopt a non-discrimination provision in its treaties[100]. It has been suggested that Australia's reason for concluding tax treaties is simply to agree upon a division of taxing rights between itself and other countries in a way that relieves double taxation and prevents fiscal evasion. From this perspective, non-discrimination is not necessary. Apparently, Australia feels that the advantages of non-discrimination provisions do not outweigh their disadvantages. In particular, such provisions could conflict with what Australia considers a proper division of taxing rights between the Contracting States (e.g. by restricting Australia's right to impose a branch profits tax, by preventing Australia from applying thin capitalization rules to foreign-owned companies, etc.). Moreover, Australia seems to be concerned that a non-discrimination provision would preclude it from adopting some tax measures intended principally for economic regulation, rather than revenue raising: as particular problems may arise only in relation to, for instance, foreign-owned companies, the ability to deal with such problems through measures affecting only those companies should not be impaired. Finally, Australia seems to consider the language of Art. 24 too imprecise[101].

As a general remark, it is to be noted that the comparison under Art. 24 OECD MC should always be at the level of the individual taxpayer and not at the level of the class of taxpayers to whom the taxpayer belongs. Consequently, a tax measure violates Art. 24 OECD MC if one particular taxpayer is treated less favourably, but other taxpayers in the same group enjoy advantages from that measure[102]. Additionally, the legislation of a State can only be said to constitute discrimination if the disadvantage incurred by the taxpayer is **due to** that

---

[100] Until 2008, Australia reserved its position on Article 24 in Comm. OECD on Art. 24, para. 85. This reservation has been replaced as follows in 2008: *"Australia reserves the right to propose amendments to ensure that Australia can continue to apply certain provisions of its domestic law relating to deductions for R&D and withholding tax collection"* (Comm. OECD on Art. 24, para. 86).

[101] S. GOLDBERG and P. GLICKLICH, "Treaty-based nondiscrimination: now you see it now you don't", *Florida Tax Review* 1992, 57. It should also be noted that the non-discrimination clause in several tax treaties contains a carve-out for certain domestic measures that would otherwise infringe the non-discrimination clause. Consider, for instance, the tax treaties concluded by the U.S. after 1986, which generally contain a carve-out for the U.S. branch profits tax in Article 24(3) (see also 2.D.III.B.b.3). Similarly, a number of treaties concluded by India expressly provide that the PE non-discrimination clause does not preclude India from charging a PE's profits to a higher tax rate than the rate applicable to resident enterprises.

[102] This issue was discussed in the context of the 2008 update to the OECD MC. The Working Group considered that no changes to the Comm. OECD were needed to clarify that this is the correct interpretation of Art. 24 OEC MC, cf. OECD, "Application and interpretation of Article 24 (non-discrimination). Public discussion draft", 3 May 2007, 10.

legislation. There is no discrimination if the taxpayer incurs a disadvantage because of the interaction between the tax systems of different States (see also Part III, 2.E.II).

Moreover, it must be stressed that the different paragraphs of Article 24 concern different situations. The provisions exist side by side, without one taking precedence over the others on account of being a *lex specialis*[103]. Nevertheless, there may be a certain degree of interaction between the different paragraphs (see, in general, 2.H and, specifically with respect to the relationship between Art. 24(4) and (5), 2.F.IV).

It is also important to note that, unlike the fundamental freedoms as interpreted by the ECJ (see Part III), Art. 24 OECD MC is generally understood as not covering ‘indirect’ discrimination. The provision will therefore only come into play if the prohibited factor (i.e. nationality or residence) is used as a distinguishing criterion[104]. As a result, tax measures which do not distinguish on the basis of the prohibited criterion, but use an element which, in practice, primarily affects the persons protected by the provision, are not precluded. For instance, a distinction on the basis of residence will not fall foul of the nationality non-discrimination provision of Art. 24(1) OECD MC.

However, indirect discrimination must be distinguished from ‘disguised’ discrimination. In the latter case, the measure at issue is aimed at the protected persons, but a seemingly innocent distinguishing criterion is used in order to disguise the discrimination. That is to say, instead of distinguishing on the basis of the prohibited criterion, the distinction is made on the basis of a criterion that is inextricably linked to the prohibited criterion. ‘Disguised’ discrimination obviously falls foul of Art. 24 OECD MC[105]. The 2008 update to the Comm. OECD now expressly confirms this position[106]: *“This Article deals with the elimination of tax discrimination in certain precise circumstances. All tax systems incorporate legitimate distinctions based, for example, on differences in liability to tax or ability to pay. The non-discrimination provisions of the Article seek to balance the need to prevent unjustified discrimination with the need to take account of these legitimate distinctions. For that reason, the Article should not be unduly extended to cover so-called ‘indirect’ discrimination. For example, whilst paragraph 1, which deals with discrimination on the basis of nationality, would prevent a different treatment that is really a disguised form of discrimination based on nationality such as a different treatment of individuals based on whether or not they hold, or are entitled to, a passport issued by the State, it could not be argued that non-residents of a given State include primarily persons who are not nationals of that State to conclude that a different treatment based on residence is indirectly a discrimination based on nationality for purposes of that paragraph.”*

Another important difference between Art. 24 OECD MC and the fundamental freedoms is the decision tree of both non-discrimination standards. Under Art. 24, there are only two steps: first, it is ascertained whether the situations are comparable, after which it is determined whether the subject of comparison is treated less favourably. If those two conditions are fulfilled, there is discrimination contrary to Art. 24. The non-discrimination test developed by the ECJ under the fundamental freedoms starts with the same two steps, but then offers the

[103] K. VOGEL, *On double taxation conventions*, 1997, 1280.
[104] E.g. Comm. OECD on Art. 24, para. 8: *“In applying paragraph 1 therefore, the underlying question is whether two persons who are residents of the same State are being treated differently* ***solely by reason of having a different nationality****”* (emphasis added). See also K. VOGEL, *On double taxation conventions*, 1997, 1290.
[105] See also Part I.B, on characteristics that are inherent in the comparative attribute.
[106] Comm. OECD on Art. 24, para. 1, as updated in 2008.

possibility to justify the discrimination in a third step. It is generally accepted that there is no such possibility under Art. 24 OECD MC (see, however, Part IV, 1.B).

Furthermore, regard should be had to the special nature of Art. 24 in relation to the other provisions of the Model. While the other provisions distribute taxing powers among the Contracting States and relate only to specific types of income, Art. 24 has a wider scope. Art. 24 aims at overriding any discriminatory provision of national law coming within the scope of the Article. If the conditions of Art. 24 are fulfilled, the discriminatory provision will not be applied, but instead, the domestic rules that apply to the State's own nationals or residents (depending on the applicable paragraph of Art. 24) will be applied.

Finally, Art. 24 OECD MC should not be constructed as containing an implicit most favoured-nation (MFN) clause. The basic mechanism behind a MFN-clause is the same as the mechanism governing a provision prohibiting discrimination of non-nationals or non-residents (or prescribing equal treatment for such persons): a State must not treat one group of persons less favourably than another group of persons (or a State must treat both groups equally). The difference lies in the object of comparison. Where a nationality or residence non-discrimination (or equal treatment) provision refers to the treatment given to nationals or residents, the MFN-clause refers to the treatment given to subjects of a third State (more specifically: the subjects of the 'most favoured' State).

Both clauses, the nationality or residence non-discrimination clause as well as the MFN-clause, are thus aimed at providing a foreigner or a non-resident with a certain level of protection. The difference lies in the level of protection offered by both clauses. As States have a tendency to favour their own subjects, the level of protection offered by a MFN-clause is traditionally lower than the level of protection offerred by a non-discrimination clause[107]. Consequently, clauses of MFN treatment have appeared earlier in treaty practice than clauses of national or resident treatment. The origin of MFN clauses may even be traced back to the early Middle Ages, before the development of the first commercial treaties[108]. Throughout the middle ages, MFN-clauses were included in trade and shipping agreements between cities (or States) in order to ensure equal competition between merchants of different cities (or States)[109]. The protection accorded was merely intended to allow for a fair competition between different third-State or third-city merchants, not between those merchants and merchants trading in their home-State or home-city. In some cases, however, the inclusion of an MFN-clause was preceded by the inclusion of a national treatment clause: after the conclusion of the instrument containing the national treatment clause, other States obtained the same privileged treatment by negotiating an MFN-clause[110]. In such cases, the MFN-

[107] E.g. the 1981 treaty between Germany and the USSR, which provides in Art. 20: *"A Contracting State shall not subject a person resident in the other Contracting State to taxation which is higher or more burdensome than that to which this State would subject a person who is a resident of a third state with which no Convention for the avoidance of double taxation has been concluded."* As the contracting States failed to reach an agreement on the definition of the term 'nationality', it was impossible to include a nationality non-discrimination provision. Accordingly, they had to settle for the lower degree of protection offered by this MFN-provision (see K. VOGEL, *o.c.*, 1285-1286).

[108] In 1055, for instance, the Roman Emperor Henry III (1017-1056) granted the City of Mantua the enjoyment of all customs enjoyed *"by any other city"*; see B. NOLDE, "La clause de la nation la plus favorisée et les tariffs préférentiels", *Académie de droit international de La Haye. Recueil des cours* 1932, vol. 39, 25.

[109] E.g. the commercial treaty between England and the Duchy of Brittany of 1486; cf. B. NOLDE, *o.c.*, 26.

[110] For instance, the 1535 treaty between France the Ottoman Emire, referred to above, accorded national treatment to the subjects of both States. Gradually, France secured more and more fiscal privileges from the relatively weak Turks (e.g. Arts. XII, XIII, XVI and XXII of the Capitulations with France of 1604, *Treaties, etc. between Turkey and Foreign Powers. 1535-1855*, London, Foreign Office, 1855, 188-190 and Arts. V and VI of

clause prevents discriminations between different classes of foreigners, as well as discrimination between foreigners and nationals (because the most favoured nation has been granted national treatment).

In direct tax matters, the inclusion of MFN-provisions in treaties is quite rare. Apparently, contracting States feel that the benefits agreed upon in a tax treaty should remain confined to the residents or nationals of both contracting States. As the inclusion of a MFN-clause in a tax treaty would grant the beneficiaries of that treaty access to the entire treaty network of that State, there seems to be a general reluctance to include express MFN-provisions in tax treaties[111] [112].

Given the principle of reciprocity underlying most (if not all) tax treaties, it would be incorrect to infer that the non-discriminatory treatment granted by Art. 24 OECD MC extends to conventions concluded with third States and thus implicitly contains an MFN-clause[113]. Consequently, a State A taxpayer enjoying the protection of Art. 24 OECD MC in State B cannot invoke this provision in order to claim benefits from treaties concluded by State B with third States. The 2008 update to the Comm. OECD on Art. 24 confirms this in para. 2: *"the provisions of the Article cannot be interpreted as to require most-favoured-nation treatment. Where a State has concluded a bilateral or multilateral agreement which affords tax benefits to nationals or residents of the other Contracting State(s) party to that agreement, nationals or residents of a third State that is not a Contracting State of the treaty may not claim these benefits by reason of a similar non-discrimination provision in the double taxation convention*

the Treaty of Commerce with France of 1838, *o.c.*, 235-236). The United States and Portugal followed France's lead by the inclusion of a MFN-clause in their treaty with the Ottoman Empire: Art. I of the Treaty of Commerce with the United States of 1830, *o.c.*, 698; Art. III of the Treaty of Commerce with Portugal of 1843, *o.c.*, 406.

[111] According to P. PISTONE, *The impact of Community law on tax treaties. Issues and solutions*, London, Kluwer Law International, 2002, 208-209, those treaties that do contain MFN-provisions are often concluded with former colonies, to stimulate their economic development, or between interdependent economies such as Canada and the US. See, however, I. HOFBAUER, "Most-favoured nation clauses in double taxation conventions – A worldwide overview", *Intertax* 2005, 445-453 who disagrees with this view. According to the latter author, MFN-clauses in tax treaties are not as uncommon as generally assumed. Moreover, MFN-provisions are remarkably often included in treaties between two European States or between a European and an Asian State.

[112] In some cases, the object of comparison is limited to a specific group of taxpayers, instead of referring to "a third State" or "any other State". See, for instance, Final Protocol, Point 6 of the Treaty between Austria and Czechoslovakia for the adjustment of taxation at home and abroad, in particular for the avoidance of double taxation in the field of direct taxation, signed at Vienna, February 18, 1922 (*League of Nations Treaty Series*, 1922, Vol. XIV, No. 371): *"Nationals of the Czechoslovak Republic shall not receive less favourable treatment in connection with the capital levy in Austria* ***than that which is applicable to nationals of the Allied and Associated Powers generally****"* (emphasis added; the Allied and Associated Powers were the U.S., the British Empire, France, Italy and Japan, i.e. the main Entente forces in World War I).

[113] "Report to the Council of the Fiscal Committee of the League of Nations, 31 May 1930", *Legislative History of United States Tax Conventions*, vol. 4, 1962, 4209: *"In view of the fact that the bilateral or multilateral agreements on double taxation are based on the principle of reciprocity, that is to say, involve reciprocal treatment for the nationals of the contracting parties, the Fiscal Committee, while not wishing to give an opinion on an exceedingly difficult point of international law, considers that the application of the most-favoured-nation clause to the nationals of a country which had not acceded to the said agreements would constitute a treatment of those nationals contrary to equity and to the spirit of the clause. Nevertheless, in order to prevent this point from arising, it is desirable that in commercial or establishment treaties concluded in the future it should be made clear that the most-favoured-nation clause in its application to fiscal matters does not extend to special provisions for the avoidance of double taxation."* See also C. J. GREGG, "Double taxation", *Transactions of the Grotius Society, Vol. 33, Problems of Public and Private International Law*, 1947, 94-95; J. O'BRIEN, "The nondiscrimination article in tax treaties", *Law and Policy in International Business* 1978, 589-590; P. BAKER, *Double taxation conventions*, London, Sweet & Maxwell, 2006 (loose-leaf), 24-2/14. See also infra, Part III, 2.E.I.A.2.9, on the ECJ's position on this issue.

between the third State and the first-mentioned State. As tax conventions are based on the principle of reciprocity, a tax treatment that is granted by one Contracting State under a bilateral or multilateral agreement to a resident or national of another Contracting State party to that agreement by reason of the specific economic relationship between those Contracting States may not be extended to a resident or national of a third State under the non-discrimination provision of the tax convention between the first State and the third State[114]*."*

B. Article 24(1): nationality non-discrimination

I. General

The first paragraph of Art. 24 is aimed at preventing discrimination of any kind by one Contracting State when taxing **nationals** (individuals or legal persons) of the other Contracting State. As indicated earlier, indirect discrimination is not prohibited by Art. 24 OECD MC. Consequently, a measure that is 'mainly' to the disadvantage of non-nationals does not infringe Art. 24(1)[115]. For instance, discrimination based on the taxpayer's place of residence[116], the place of residence of a taxpayer's employer[117], the place of residence of the

[114] This position can be compared to paras. 54-55 of the 1977 Comm. OECD on Art. 24, which were deleted in 1992: *"While an enterprise of a State A can normally claim, in respect of the permanent establishment which it possesses in another State B, the benefit of the provisions of the convention between those two States A and B, it nevertheless cannot, should such permanent establishment derive income from a third State C, invoke the provisions of the convention between States B and C for the benefit of such permanent establishment since it, the enterprise, is in fact resident of neither of those two States (cf. Article 1). This is the consequence of the well-known principle of the relative effect of treaties, which means that they have effect only as between the Contracting States. Nor could such an enterprise invoke for this purpose a most-favored-nation clause, however general its terms, included in a treaty or agreement concluded between States A and B. In fact, it has always been accepted that such a clause did not apply in the case of double taxation conventions, because these are essentially based on the principle of reciprocity. It should, however, be noted that some States have made provision in their double taxation conventions enabling the provisions of the latter to be applied, 'in special cases', to permanent establishments of enterprises of a third State".* These remarks were considered to be of general application, and thus not limited to the non-discrimination Article: P. BAKER, *o.c.*, 24-2/14.

[115] See the distinction between 'indirect' and 'disguised' discrimination, discussed earlier.

[116] E.g. Indian Authority for Advance Rulings 23 April 2009, *Canoro Resources Limited v. Commissioner of Income Tax*, No. AAR/779/2008, *IBFD Tax Treaty Case Law*: Indian transfer pricing provisions that did not apply to transactions between residents were not contrary to Art. 24(1). The AAR notes that Article 24(1) *"prohibits a Contracting State from making any discrimination in the matter of taxation between its own national and a national of the other Contracting State, who are placed in similar circumstances. In other words, a Contracting State is obliged to provide the same tax treatment to a national of the other Contracting State as it would give to its own nationals. […] The transfer pricing provisions relate to international transactions between associated enterprises. […] 'International transaction' has been defined in section 92B of the Act to mean transaction between enterprises, either or both of whom are non-residents. It may also be seen that section 92B makes a distinction between enterprises on the basis of their residential status, and not with reference to their nationality. As we know, the residential status of an individual depends on the number of days he lives in India. In the case of a legal person, like a company, or in the case of a firm, it would depend on factors, such as place of registration, situs of control and management, etc. It is possible that a national of India could be a non-resident for the purpose of this Act and a national of the other Contracting State could be a resident. Be that as it may, a cross-border transaction between Indian nationals, one or both of whom are non-residents and who are associated enterprises, will also attract the transfer pricing provisions, as they would apply to similarly situated Canadian nationals. Viewed from this angle, the plea of discrimination raised by the applicant has no basis."*

[117] E.g. a Dutch anti-avoidance measure with regard to intermediate employment companies contained the condition that the employer was resident in the Netherlands, cf. I. BLEEKER and S. VAN THIEL, "Cyprus Construction terminated", *European Taxation* 1986, 127-130

taxpayer's spouse[118] or the origin of a pension[119] does not fall foul of Art. 24(1). The 2008 Update to the Comm. OECD on Art. 24 expressly confirms this in para. 1 (see supra).

II. No taxation without discrimination?

Given the relatively minor importance of nationality in the individual income tax system of most States, it might be somewhat surprising that Art. 24(1) uses nationality as a reference point[120]. Only where a State favours its own nationals will the provision come into play. With regard to companies, however, nationality is of greater importance in national tax systems: many States attach full tax liability to incorporation in that State. Thus, a nationality non-discrimination provision seems to require these States to extend benefits attached to such full tax liability to foreign companies.

In this regard, attention must be drawn to the difference between the jurisdictional basis for income tax liability and the ground for non-discriminatory treatment. A jurisdictional basis for tax liability is by definition discriminatory, as it makes a distinction between persons who are subject to tax on their worldwide income and persons who are merely subject to tax on certain items of income. Most States use the criterion of residence as a jurisdictional basis for income tax liability: residents of a State are liable to tax on their worldwide income, whereas non-residents are only subject to tax on the income sourced in that State. These States will wish to exclude residence from general non-discrimination provisions. If not, the distinction between limited and full tax liability will be interfered with, as benefits which are only available to full liability taxpayers would have to be extended to restricted liability taxpayers. Similarly, the few States which do use nationality as a jurisdictional basis for income tax liability (e.g. the USA), will wish to restrict their obligations under a nationality non-discrimination provision such as Art. 24(1). Specifically, they will restrict the non-discriminatory treatment to benefits which are object-related. Benefits which are granted to full liability taxpayers solely because they are full liability taxpayers will be excluded from the non-discrimination obligation: full liability taxpayers are taxed on the basis of their personal ability to pay, whereas the taxation of limited liability taxpayers is object-oriented[121]. Since this issue is closely related to the issue of comparability, it will be addressed in 2.B.V.A.

In 1992, the condition that all relevant circumstances, except for nationality, must be the same, was clarified by adding that the place of residence is essential in determining whether two taxpayers are in the same circumstances. In other words, if the two taxpayers are in different circumstances with regard to residence, they cannot be compared for purposes of Art. 24(1). As a result, two groups of taxpayers must be distinguished: nationals of

---

[118] E.g. US Tax Court 29 June 1992, No. 6739-90, 98 *T.C.* 695.

[119] E.g. Supreme Administrative Court of Sweden, *RÅ* 1988, ref 154 (discussed in K. STÅHL, "The application of the treaty non-discrimination principle in Sweden", *Intertax* 2000, 195). The taxpayer was a Norwegian national residing in Sweden whose main income was a Norwegian pension. Under Swedish law at the time, a person whose main income consists of a Swedish state pension was entitled to a tax reduction. The taxpayer argued that he was being discriminated against, as he could not enjoy this benefit. The Court, however, decided that the denial of the benefit did not violate the nationality non-discrimination provision of the applicable treaty, as a Swedish national in the same circumstances (i.e. whose main income consisted of a Norwegian pension) would be denied the benefit as well.

[120] This approach can be explained by the origin of the provision: as indicated above, the non-discrimination provision in bilateral tax treaties is based on nationality non-discrimination provisions found in commercial treaties, consular conventions, etc.

[121] K. VAN RAAD, *Nondiscrimination in international tax law,* 1986, Kluwer, Deventer, 74.

Contracting State A who are residents of Contracting State B on the one hand, and nationals of Contracting State A who are non-residents of Contracting State B on the other hand. When determining whether there is discrimination under Art. 24(1) in State B, a national of State A who is resident in State B must be compared to a national of State B who is also resident in State B. By contrast, a national of State A who is non-resident in State B must be compared to a national of State B who is also non-resident in State B. Within both groups - either the group of the residents, or the group of non-residents - nationality discrimination is prohibitied.

It might be argued, however, that 'in the same circumstances, in particular with respect to residence' implies that the object of comparison is even more limited. From the point of view of the (alledgedly) discriminating State (State B in the example) residents of State A and residents of State C are in the same circumstances with respect to residence: both are non-resident in State B. From the point of view of the taxpayer, however, the circumstances are different: a resident of State A is not in the same circumstances with respect to residence as a resident of State C. Given the purpose of the provision (i.e. to prohibit more burdensome taxation of non-nationals by Contracting States) and the fact that the rule of Art. 24(1) is a limitation to State B's sovereignty, the relevant point of view seems to be that of the (allegedly) discriminating State. In relation to State B, residents of State A and residents of State C are both in the same circumstances with regard to residence: both are non-resident in State B. Consequently, the object of comparison for a State A national who resides in State A, is a State B national who does not reside in State B (but, for instance, in State A or in State C). The Commentary on Art. 24, however, takes another approach: *"In applying paragraph 1 therefore, the underlying question is whether two persons **who are residents of the same State** are being treated differently solely by reason of having a different nationality. […] Similarly, paragraph 1 does not apply where a national of a Contracting State (State R) who is also a resident of State R is taxed less favourably in the other Contracting State (State S) than a national of State S residing in a third State (for instance, as a result of the application of provisions aimed at discouraging the use of tax havens) **as the two persons are not in the same circumstances with respect to their residence**"*[122].

Consequently, the Commentary suggests that the object of comparison for a State A national who feels he is being discriminated against in State B and resides in State A, is a State B national who resides in State A[123]. By contrast, a State B national residing in State C would not be in the same circumstances as the State A national. In my opinion, that interpretation is overly restrictive. As noted above, it should not make a difference for State B whether a non-resident resides in State A or in State C. Of course, it is possible that there are particular reasons to distinguish between different types of non-residents (e.g. the example of tax havens, referred to in the quoted Commentary), but that does not mean that it can be said *a priori* that non-residents must reside in the same State in order to be comparable.

III. Nationality

[122] Comm. OECD on Art. 24, para. 8 (emphasis added).

[123] Similarly, Swedish Supreme Administrative Court 23 November 1999 (Regeringsrätten no. 2772-1999, 2 *ITLR* 602), in which a company incorporated (nationality) and having its place of effective management (residence) in an EEA State was compared to a company having Swedish nationality that was resident in the EEA State. Since the latter was taxed on a net basis while the former was taxed on a gross basis, the Court held that there was discrimination contrary to the nationality non-discrimination clause of the applicable tax treaty.

In order to invoke Article 24(1), the taxpayer must be a national of one of the Contracting States. The term national is defined in Art. 3(1)(g) as[124]: *"(i) any individual possessing the nationality or citizenship of that Contracting State; and (ii) any legal person, partnership or association deriving its status as such from the laws in force in that Contracting State."*

III.A. Individuals

In the case of individuals, the term 'national' refers to persons possessing the nationality or citizenship of the Contracting State. The reference to citizenship was added in 2003 (cf. supra). The OECD Commentary on Art. 3 indicates that, whilst the concept of nationality covers citizenship, the latter term was also included because it is more frequently used in some States. Further, the Commentary states that it *"was not judged necessary to include in the text of the Convention any more precise definition of the terms nationality and citizenship, nor did it seem indispensable to make any special comment on the meaning and application of the word. Obviously, in determining what is meant by 'nationals' in the case of an individual, reference must be made to the sense in which the term is usually employed and each State's particular rules on the acquisition or loss of nationality or citizenship"*[125]. This reference to the domestic rules of one State on the acquisition or loss of nationality or citizenship might require the authorities of the other State to interpret these rules.

In order to define the term 'national' with regard to individuals, Art. 3 refers to the nationality provisions of the contracting States' domestic law. Consequently, nationality is determined by the law of the State the nationality of which is concerned[126]. Thus, it is irrelevant whether or not the national of one contracting State is at the same time also a national of a third State: he can invoke Art. 24(1) in his capacity as a national of a contracting State. If an individual is a national of both contracting States, no nationality discrimination issues will arise, as each contracting State will treat the individual as a national[127].

III.B. Other persons

a. General

In the case of legal persons, partnerships and associations, nationality is determined by reference to the legal system from which its status is derived (*"deriving its status as such from the laws in force in that Contracting State"*). The OECD MC does not contain a definition of the term 'legal person'. In order to verify whether an entity qualifies as a legal person, reference should not be made to the law of the discriminating State via Art. 3(2) OECD MC, but rather to the law of the State of incorporation. The wording of Art. 3(1) (g)

[124] In the 1963 OECD Draft Convention and the 1977 OECD MC, this definition could be found in Art. 24(2): see supra.
[125] Comm. OECD on Art. 3, para. 8.
[126] K. VOGEL, *o.c.*, 196.
[127] Except, of course, in one of two hypothetical cases. First, if a State would decide to discriminate against dual nationals. Secondly, a taxpayer having both the nationality of State A and State B is discriminated against in State A when there is a provision in State A's law **against** State B nationals, regardless of whether or not they are also State A nationals. In both cases, an OECD-style nationality non-discrimination provision would be violated, as the taxpayer is treated less favourably on the grounds of nationality.

makes this clear: *"any legal person […] deriving its status as such from the laws in force in that Contracting State"*[128].

With regard to partnerships and associations, the wording of Art. 3(1) (g) indicates that reference is made to partnerships and associations without legal personality ("*any legal person, partnership or association*")[129]. Despite this lack of legal personality, some States may subject such partnerships or associations to tax, which explains their inclusion in the non-discrimination provision. In case the entity is disregarded for tax purposes, the non-discrimination provision applies at the level of the partners, provided they are nationals of one of the Contracting States[130]. Complex situations may arise with regard to partnerships or associations which are treated as taxable entities in the State of organization, whereas the source State of the income does not consider them to be taxable entities but taxes the income in the hands of the partners. Issues with respect to treaty entitlement of partnerships in such cases go well beyond the scope of this study. I therefore refer to the plethora of literature on the subject[131].

It is strange that the OECD MC does not use the definition of a 'person' of Art. 3(1) (a) OECD MC, considering that the expression *"**persons** who are not residents of [either State]"* is used in the second sentence of Art. 24(1) OECD MC. A 'person' is defined as *"an individual, a company and any other body of persons"*. A 'company' is *"any body corporate or any entity that is treated as a body corporate for tax purposes"* (Art. 3(1)(b) OECD MC)[132]. The problem is that the first sentence of Art. 24(1) OECD MC refers to 'nationals' (i.e. *"any individual possessing the nationality or citizenship of that Contracting State and any legal person, partnership or association deriving its status as such from the laws in force in that Contracting State"*), whereas the second sentence declares that the provision also applies to 'persons' (i.e. *"an individual, a company and any other body of persons"*) who are not residents of one or both of the Contracting States. However, both terms do not overlap entirely. The term 'national', for instance, includes associations which are not legal persons and which are not taxed as companies. Such entities would therefore not be 'persons' as defined by Art. 3, if one interprets the expression 'any other body of persons' as excluding such associations. On the other hand, the term 'persons' includes entities which are taxed as companies, but which are not legal persons. Since they are not legal persons, they seem to fall outside the scope of the definition of 'nationals'[133]. However, such entities are often partnerships or associations, which would mean that they could still qualify as nationals on that basis.

It has been suggested that the OECD MC in its definition of the term 'national' does not refer to the term 'companies' (as defined by Art. 3(1)(b) and including entities taxed as a body corporate) because the nationality non-discrimination provision applies to all taxes. Whether

---

[128] K. VAN RAAD, *Nondiscrimination in international tax law*, 1986, Kluwer, Deventer, 83.
[129] See also Comm. OECD on Art. 3, para. 9 and 10.1.
[130] K. VOGEL, *o.c.*, 196.
[131] E.g. J. AVERY JONES, L. DE BROE, *et al.*, "Characterization of other States' partnerships for income tax", *Bulletin for International Taxation* 2002, 288-320; OECD, "The application of the OECD model tax convention to partnerships", 1999, Paris; *Cahiers de droit fiscal international. International income tax problems of partnerships*, Vol. 80a, Amersfoort, Sdu Fiscale & Financiële Uitgevers, 1995.
[132] It should be noted that Art. 3(1)(b) uses the term 'body corporate' in the definition of a company, while Art. 3(1)(g) uses the term 'legal person', even though there is no difference in meaning between the terms in English. In French, both provisions use the same term, 'personne morale'. Cf. also J. AVERY JONES, *et al.*, "The non-discrimination article in tax treaties", *European Taxation* 1991, 324; K. VAN RAAD, *o.c.*, 83.
[133] K. VOGEL, *On double taxation conventions*, 1997, 1291.

or not an entity is subject to income or capital tax covered by the treaty should therefore not be relevant to the question whether the entity is protected against nationality discrimination with respect to other taxes to which it may be subject[134].

b. The nationality of legal entities

1. General

a. The position taken in the Commentary

Since Art. 24(1) requires the circumstances to be the same *"in particular with respect to residence"*, it is important to distinguish nationality from residence. The definition of the term 'resident of a Contracting State' in Article 4 OECD MC refers to any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature. In the case of companies, however, the distinction between residence and nationality is often less clear-cut than in the case of individuals. Many States use a broad range of criteria to define the connecting factors between a company and that State's jurisdiction. Nationality and residence may overlap, as the same criteria are often used. In particular, the domestic law of many countries uses incorporation or registration as the criterion (or one of the criteria) to determine the residence of companies for purposes of Article 4. Under the definition of Article 3(1)(g), however, registration or incorporation will also be the criterion to determine the 'nationality' of a company (since a company will usually *"derive its status as such from the laws in force"* in the State in which it has been incorporated or registered).

The Commentary on Art. 3 addresses the nationality of companies in paras. 9-10: *"By declaring that any legal person, partnership or association deriving its status as such from the laws in force in a Contracting State is considered to be a national, the provision disposes of a difficulty that often arises. In defining the nationality of companies, certain States have regard less to the law that governs the company than to the origin of the capital with which the company was formed or the nationality of the individuals or legal persons controlling it. Moreover, in view of the legal relationship created between the company and the State under whose law it is organised*[135]*, which from certain points of view is closely akin to the relationship of nationality in the case of individuals, it seems justifiable not to deal with legal persons, partnerships and associations in a special provision, but to assimilate them with individuals under the term 'national'."*

As nationality is determined by reference to the legal system from which its status is derived, the non-discrimination provision with regard to a legal entitity boils down to a prohibition of less favourable treatment by reason of it not being organized under the laws of the taxing State. The French text of the OECD MC differs somewhat in this regard as it refers to *"toute*

[134] J. AVERY JONES, *et al., o.c.*, 324.
[135] The expression *"the State under whose law it is organised"* (*"l'Etat sous la loi duquel elle a été formée"*) appears to refer to the State of incorporation in both English and French. Before 1995, the English text used the word 'constituted', rather than 'organised'. Interestingly, Comm. OECD on Art. 24, para. 16 is very similarly worded, but still refers to 'constituted' ('formée' in French), rather than 'organised. The text reads: *"In view of the legal relationship created between the company and the State under whose law it is constituted, which from certain points of view is closely akin to the relationship of nationality in the case of individuals, it seems justifiable not to deal with legal persons, partnerships and associations in a special provision, but to assimilate them with individuals under paragraph 1. This result is achieved through the definition of the term 'national' in sub-paragraph (f)* [the Comm. OECD erroneously refers to sub-paragraph (f), instead of sub-paragraph (g); N.B.] *of paragraph 1 of Article 3"*.

personne morale, société de personnes ou association ***constituée conformément à la législation en vigueur*** *dans cet Etat contractant"*, meaning legal persons, partnerships or associations **incorporated**[136] in accordance with the law in force in a contracting State[137]. It has been suggested that the difference between both language versions may be explained by the argument that the word 'incorporated' would not have been approprate in English to apply to legal persons, partnerships and associations[138]. Even so, other options, such as 'formed'[139] or 'organised'[140], were available and might have been more easily reconcilable with the French version than the current 'deriving its status as such'[141]. Despite this confusing choice of words, it is submitted that both the English 'deriving its status as such' and the French 'constitué' refer to the same idea, namely the law that governs the company.

The reference to *"the law that governs the company"* (*"la loi qui régit la société"*) in para. 9 of the Commentary on Art. 3 requires a distinction to be made between two conflicting views on which law 'governs' a company. According to the first view, which is adopted by most common law countries, 'the incorporation principle', a company is governed by the law of the State of incorporation[142]. A foreign company is recognised so long as it exists according to the law of its State of incorporation. As common law countries only consider the law of incorporation, there is no difference between a company's nationality, its residence or the place of its registered office: the State of incorporation would thus be regarded as its State of residence, rather than its nationality. Under the second view, the 'central administration principle', a company is governed by the law of the State where it has its real seat (*"siège réel"* in French, *"tatsächlicher Sitz"* in German), i.e. its central administration (*"administration centrale"* in French, *"Hauptverwaltung"* in German)[143]. In some central administration States, a company having its central administration there, but incorporated elsewhere, is not merely recognised but is also governed by the law of the State in which the

---

[136] Incorporation does not necessarily refer to the original State of incorporation, as, under the corporate law of many States, a company may effectively move its place of incorporation and continue as if it had been incorporated in the second State; cf. J. AVERY JONES, *et al.*, "The non-discrimination article in tax treaties", *European Taxation* 1991, 315-316.

[137] Similarly, German and Italian treaties use the expressions *"die nach dem in diesem Vertragsstaat geltenden Recht errichtet worden ist"* and *"costituite in conformità della legislazione in vigore in uno Stato contraente"*, respectively. The Dutch version of the Belgian 'Standard Model', which is used during treaty negotiations, uses the expression *"waarvan de rechtspositie als zodanig is ontleend aan de wetgeving die in die overeenkomstsluitende Staat van kracht is"*. This is a literal translation of the English text of the OECD MC. By contrast, the French version of the Standard Model uses the expression *"constituée conformément à la législation en vigueur dans cet Etat contractant"*, which is in line with the French text of the OECD Commentary.

[138] J. AVERY JONES, *et al.*, "The origins of concepts and expressions used in the OECD Model and their adoption by States", *British Tax Review* 2006, 710-711.

[139] This word is used in relation to companies in Comm. OECD on Art. 3, para. 9; see supra.

[140] See supra, footnote 135.

[141] According to J. AVERY JONES, *et al.*, *o.c.*, 711, the expression "deriving its status as such" was first used in the 1945 treaty between the U.S. and the U.K. The non-discrimination Article of that treaty included a definition of nationals which stated that *"the term 'nationals' as used in this Article […] includes all legal persons, partnerships and associations* ***deriving their status as such*** *from, or created or organized under, the laws in force in any territory of the Contracting Parties to which the present Convention applies"*, C. BEVANS, *Treaties and Other International Agreements of the United States of America 1776-1949*, Vol. 8, Washington, U.S. Government Printing Office, 1968, 682 (emphasis added).

[142] States adhering to this view are, *inter alia*, Australia, Canada, Italy (in part), the Netherlands, Sweden, Switzerland, the U.K. and the U.S.; cf. J. AVERY JONES, *et al.*, "The origins of concepts and expressions used in the OECD Model and their adoption by States", *British Tax Review* 2006, 708.

[143] States adhering to this view are, *inter alia*, Belgium, France, Germany, Italy (in part) and Japan.

central administration is based, as long as it is capable of complying with that law[144]. In such cases, the company will not be considered as being reincorporated, but it continues as a foreign incorporated company governed by the law of the State of central administration[145].

The difference between the English version and the French version of the OECD MC (see supra) may lead to a divergent application of tax treaties, depending on the language used. In particular, the French text may require that one applies the law of the State of incorporation, whereas the English text may instead refer to the law governing the company. In particular, a company having its central administration in a central administration State is governed by the law of that State. Under the English text of the OECD MC, such a company might be regarded as a national of that State, as it derives its status as such solely (as far as the central administration State is concerned) from that State's law. However, if the company would be incorporated in a State adhering to the incorporation principle, the latter State would still regard it as deriving its status from the State of incorporation[146]. Thus, in cases where English is the only official language of the treaty[147], the nationality test of the treaty may be inconclusive[148].

In case a tax treaty based on the OECD MC has been authenticated in English as well as in French[149], the rule of Art. 33(4) of the Vienna Convention should apply[150]. Consequently, preference should be given to the meaning which best reconciles the texts, having regard to the object and purpose of the treaty. It has been suggested that the French text is preferable, not because this is dictated by the object and purpose of the treaty, but because its meaning is more precise[151].

b. The 2008 update

The 2008 update to the Comm. OECD has further addressed the existing difficulties by amending the Commentary on Art. 24 as follows: *"A company will usually derive its status as such from the laws in force in the State in which it has been incorporated or registered. Under the domestic law of many countries, however, incorporation or registration constitutes the criterion, or one of the criteria, to determine the residence of companies for the purposes of Article 4. Since paragraph 1 of Article 24 prevents different treatment based on nationality*

---

[144] Examples include Belgium and France. For a general overview, see G. MAISTO (ed.), *Residence of companies under tax treaties and EC law*, Amsterdam, IBFD, 2009.
[145] J. AVERY JONES, *et al.*, *o.c.*, 708-709.
[146] Cf. J. AVERY JONES, *et al.*, *o.c.*, 712, referring to the company in the *Überseering* case (ECJ 5 November 2002, *Überseering*, C-208/00, ECR 2002 I-09919) as an example of such a situation.
[147] Or another language version which contains a literal translation of the expression "deriving its status as such", e.g. the Dutch version of the Belgian Standard Model, referred to above.
[148] It should be borne in mind that it is unlikely that English would be the only official language of a treaty involving a central administration State, as English is not an official language in most of these States. An example is the 1968 treaty between Belgium and Japan, the only version of which is in English. Nationals are defined in Art. 24(2) as *"in respect of Japan: all individuals possessing the nationality of Japan and all juridical persons created or organized under the laws of Japan and all organizations without juridical personality treated for the purposes of Japanese tax as juridical persons created or organized under the laws of Japan […] in respect of Belgium: all individuals possessing the nationality of Belgium and all legal persons, partnerships and associations deriving their status as such from the law in force in Belgium."* Consequently, a Japanese incorporated company having its central administration in Belgium may be regarded as a national of each country under this interpretation.
[149] Or in other languages reflecting the divergence between the English text and the French text.
[150] Vienna Convention on the Law of Treaties, signed in Vienna on 23 May 1969, and entered into force on 27 January 1980.
[151] J. AVERY JONES, *et al.*, "The non-discrimination article in tax treaties", *European Taxation* 1991, 318.

but only with respect to persons or entities 'in the same circumstances, in particular with respect to residence', it is therefore important to distinguish, for purposes of that paragraph, a different treatment that is solely based on nationality from a different treatment that relates to other circumstances and, in particular, residence. [Art. 24(1)] only prohibits discrimination based on a different nationality and requires that all other relevant factors, including the residence of the entity, be the same. The different treatment of residents and non-residents is a crucial feature of domestic tax systems and of tax treaties; when Article 24 is read in the context of the other Articles of the Convention, most of which provide for a different treatment of residents and non-residents, it is clear that two companies that are not residents of the same State for purposes of the Convention (under the rules of Article 4) are usually not in the same circumstances for purposes of paragraph 1."[152]

These clarifications were brought about as a result of the persistent difficulties in the application of the nationality non-discrimination provision to companies. As noted above, it is often difficult to distinguish a company's residence from its nationality, which has led some States to question whether Art. 24(1) OECD MC should apply to companies[153]. These States have argued that paragraphs 3, 4 and 5 of Article 24 may be sufficient to protect companies from discriminatory treatment and that it may be better not to apply Art. 24(1) to companies, given the risk of it being interpreted so as to prevent different treatment of resident and non-resident companies[154]. The 2008 update has not followed that approach. Instead, it stresses that resident and non-resident companies are not in the same circumstances for purposes of Art. 24(1), except where residence is totally irrelevant with respect to the measure under consideration[155].

Therefore, a different treatment of resident and non-resident companies is allowed by Art. 24(1), even where residence and nationality are linked through the criterion of incorporation or registration. The provision only prohibits a different tax treatment that is based exclusively on the fact that the entity derives its status from the domestic law of another State and requires that all other relevant factors, including the residence of the entity, be the same. Several examples are given in the amended Commentary in order to further elucidate this position[156].

The first example is a clear situation of nationality discrimination. The comparison is made between two companies, one being incorporated in State A and the other being incorporated in State B. Under the domestic income tax law of State A, companies incorporated in State A or having their place of effective management in that State, are State A residents. If the company incorporated in State B has its place of effective management in State A, it is in the same the circumstances with regard to residence as the company incorporated in State A (as both are State A residents). Consequently, a State A tax measure according benefits to

[152] Comm. OECD on Art. 24, para. 17.
[153] OECD, "Application and interpretation of Article 24 (non-discrimination). Public discussion draft", 3 May 2007, 10-11.
[154] According to the OECD discussion draft, such a result would be clearly unintended as this distinction is a crucial feature of most tax systems (see e.g. the reservation by France in Comm. OECD on Art. 24, para. 88). For instance, source based and worldwide taxation are not comparable and withholding taxes that often apply only to payments to non-residents are implicitly allowed under provisions such as Articles 10 and 11 OECD MC (OECD, "Application and interpretation of Article 24 (non-discrimination). Public discussion draft", 3 May 2007, 11)
[155] Comm. OECD on Art. 24, para. 18: *"Whilst residents and non-residents are usually not in the same circumstances for the purposes of paragraph 1, it is clear, however, that this is not the case where residence has no relevance whatsoever with respect to the different treatment under consideration."* For an example where residence is irrelevant, see the fourth example given in the amended Commentary (discussed hereafter).
[156] Comm. OECD on Art. 24, para. 19-25.

companies incorporated in State A and not to other companies would amount to a form of nationality discrimination with regard to the company incorporated in State B. In such a case, Art. 24(1) OECD MC would obviously be violated.

The second example is somewhat more complicated. Under the domestic tax law of State A, companies incorporated in that State are residents and companies incorporated abroad are non-residents. The State A/B tax treaty is identical to the OECD MC except that it provides that if a legal person is a resident of both States, it shall be deemed to be a resident of the State in which it has been incorporated. The domestic tax law of State A provides that dividends paid to a company incorporated in that State by another company incorporated in that State are exempt from tax.

The Commentary indicates that Art. 24(1) OECD MC does not extend that favourable treatment to dividends paid to a company incorporated in State B. Given the tie-breaker rule in the treaty, such a company can never be in the same circumstances with respect to residence as a company incorporated in State A. Furthermore, residence is a relevant factor in this case, which is illustrated in the Comm. OECD by a reference to Art. 10(5) OECD MC, *"which would prevent the subsequent taxation of dividends paid by a non-resident company but not those paid by a resident company."* Consequently, the scope of application of the nationality non-discrimination provision would be severely restricted if the dual residence tie-breaker rule is altered by using incorporation as the decisive criterion[157].

The applicable treaty in **the fourth example** is identical to the applicable treaty in the second example (i.e. the treaty follows the OECD MC but the dual residence tie-breaker rule uses incorporation as the decisive criterion). The connecting factors used in State A's domestic law in order to determine residence are identical to those in example 2 as well (i.e. incorporation). At issue is State A's payroll tax law, which applies to all companies that employ resident employees. The law does not make any distinction based on the residence of the employer, but it provides that only companies incorporated in State A shall benefit from a lower rate of payroll tax.

In this example, a company incorporated in State B can never be in the same circumstances with respect to residence as a company incorporated in State A. However, the difference in residence does not preclude the application of Art. 24(1) in this case, as the difference in residence has no relevance at all with respect to the different tax treatment under the payroll tax. Consequently, if all other relevant circumstances are the same, this measure would violate Art. 24(1).

The applicable treaty in **the fifth example** is also identical to the applicable treaty in the second example. At issue is the group consolidation regime in State A[158]. Under State A's domestic tax law, companies incorporated in that State or having their place of effective management there are State A residents while companies that do not meet one of those conditions are non-residents. Under the domestic tax law of State B, companies incorporated

---

[157] Such a tie-breaker rule is not used very often in practice. To my knowledge, not a single tax treaty concluded by Belgium uses incorporation as the decisive criterion for the residence tie-breaker rule; see N. BAMMENS, "Belgium", in G. MAISTO (ed.), *Residence of companies under tax treaties and EC law*, Amsterdam, IBFD, 2009, 397-401.

[158] Arguably, the example was inspired by the facts in the 29 January 2003 decision of the German Bundesfinanzhof, 6 *ITLR* 318, in which the court held that a U.S. company, managed in Germany, was eligible for the German *Organschaft* (tax grouping) regime (see 2.F.III.B.a).

in State B are residents. The domestic tax law of State A further provides that companies that have been incorporated and that have their place of effective management in State A are entitled to consolidate their income for tax purposes if they are part of a group of companies that have common shareholders. Company X, which was incorporated in State B, belongs to the same group as two companies incorporated in State A and all these companies are effectively managed in State A. Since it was not incorporated in State A, company X is not allowed to consolidate its income with that of the two other companies.

As a result of the tie-breaker rule, company X can never be in the same circumstances with respect to residence as a company incorporated in State A. Even though company X is a resident of State A under the domestic law of that State (i.e. because its place of effective management is based in State A), it is not a State A resident for treaty purposes. Consequently, it is not in the same circumstances with respect to residence as the other companies of the group. The Commentary therefore concludes that Art. 24(1) cannot be invoked in order to claim application of the consolidation regime in State A. Residence is a relevant factor with respect to the consolidation regime at issue, as certain treaty provisions would prevent State A from taxing certain types of income derived by company X (e.g. Arts. 7 and 10 OECD MC)[159].

Finally, the applicable treaty in **the third example** does not deviate from the OECD MC. Under the domestic law of State A, companies that are incorporated in that State are State A residents. Under the domestic law of State B, companies that have their place of effective management in that State are State B residents. The domestic tax law of State A provides that a non-resident company that is a resident of a State with which State A does not have a tax treaty that allows for the exchange of tax information is subject to an annual tax equal to 3% of the value of its immovable property instead of a tax on the net income derived from that property.

The question arises whether a company incorporated in State B, but which is a resident of a State with which State A does not have a tax treaty allowing for the exchange of tax information, can invoke Art. 24(1) OECD MC by claiming that it is being treated less favourably than a national of State A (i.e. a company incorporated in State A). The Commentary indicates that Art. 24(1) OECD MC is not violated in such a case, as the company in question is not in the same circumstances with respect to residence as a company

[159] The fifth example was included following comments made by BIAC (the Business and Industry Advisory Committee to the OECD) on the possibility that Art. 24(1) might require a State to extend the provisions of its domestic law that apply to a group of companies (e.g. group relief of losses, consolidation, tax-free transfers between group companies) to cover companies of the group that are not residents of that State. The following example was given: *"head office expenses, e.g. those of a general and administrative nature incurred for the benefit of a multinational group, are charged on a prorata basis among the global affiliates in the group. Country X does not accept such charges as deductible by the local X group affiliate, where the expense is incurred abroad and it is charged by a non-local entity to the local group member. BIAC suggests that this is a clear case of discrimination, where the pro rated expenses would be deductible if the expenses were incurred locally and charged through a local entity. The application of paragraph 1 to companies, especially in the case of double residence, is obviously relevant in this case. This has led to the question whether, based on the earlier conclusions on the scope of paragraph 1, this paragraph has limited application to regimes applicable to groups of related companies."* The Working Group responded as follows: *"The Working Group agreed to clarify the effect of the limited scope of paragraph 1 to regimes applicable to groups of related companies by including an example into the Commentary. This would sufficiently deal with this issue taking into account the further proposed changes to the Commentary in respect of paragraph 1. Paragraph 1 may still be applicable to resident companies subject to unlimited taxation who are simply not incorporated in that State."* (OECD, "Application and interpretation of Article 24 (non-discrimination). Public discussion draft", 3 May 2007, 6-7).

incorporated in State A. Residence is a relevant factor in this case, *"e.g. for purposes of accessing the information necessary to verify the net income from immovable property derived by a non-resident taxpayer."*

The 2008 update thus answers the question as to whether Art. 24(1) OECD MC should apply to companies in the positive, but at the same time underlines that the importance of the provision is quite limited for companies: the different tax treatment of legal persons having a different nationality and residence does not amount to a violation of Art. 24(1) OECD MC (unless the taxpayer's residence is totally irrelevant to the tax measure at issue[160]). The examples given in the Commentary are certainly helpful in understanding the OECD's position, but it is unfortunate that three of the five examples are based on a tax treaty with a residence tie-breaker rule that uses incorporation as the decisive criterion. Since such tie-breaker rules are not very common in practice, the actual relevance of these examples is quite limited. On the other hand, the Commentary's emphasis on the **relevance** of the circumstances, and in particular the relevance of residence, is to be applauded. As argued earlier, comparability is essentially concerned with relevance. Two situations are comparable when the characteristics that are relevant from the perspective of the domestic measure under scrutiny are identical. For that reason, it cannot be said *a priori* that two nationals are rendered incomparable by their difference in residence. Indeed, the situations are only incomparable if that difference in residence is relevant from the perspective of the measure at issue.

2. Case law

a. Transvaal Special Income Tax Court 10 March 1992[161]

A South African case of 1992 illustrates these issues. The taxpayer, a company incorporated in the Netherlands and having its place of effective management there, received dividends from a subsidiary established in South Africa. Under South African tax law at the time, a 'shareholders' tax' was levied on dividends paid by a company incorporated in South Africa to a company incorporated in another State[162]. The taxpayer was liable to this tax upon the payment of the dividends by its South African subsidiary. The taxpayer objected against this assessment, arguing that the South African regime constituted discrimination on the basis of nationality and was therefore contrary to Art. 25(1) of the 1971 treaty between South Africa and the Netherlands[163].

The Court first held that the taxpayer, as a company incorporated under the law of the Netherlands, was a legal person deriving its status as such from the law in force in the Netherlands. As a result, Art. 25(1) of the treaty precluded South Africa from treating the taxpayer less favourably than a company incorporated in South Africa in the same

[160] E.g. the payroll tax in the fourth example.
[161] 54 SATC 456 (T)
[162] The relevant provision of South African tax law read as follows: *"The non-resident shareholders' tax shall be paid in respect of the amount of any dividend […], if the shareholder to whom that dividend or interim dividend has been paid or is payable is […] a company which is not a South African company."* A 'South African' company was defined as a company incorporated in South Africa.
[163] Which was, in substance, identical to Art. 24(1) of the 1977 OECD MC. Art. 25(2) of the treaty was identical to Art. 25(2) of the 1977 treaty. Accordingly, the definition of 'nationals' in respect of legal persons was: *"all legal persons, partnerships and associations deriving their status as such from the law in force in a Contracting State."*

circumstances[164]. The Court then noted that the sole criterion for the imposition of the tax was the nationality of the company. As a result, the application of that tax was contrary to Art. 25(1) of the treaty.

In order to illustrate this conclusion, the Court gives the following example. Two companies, A and B, are resident in the Netherlands and both companies acquire shares in a South African company on the same date. The South African company pays dividends of equal sums to the two companies on the same date. In other words, *"the circumstances of both companies are virtually identical"*. The discriminatory effect of the South African legislation becomes apparent if company A happened to be a South African company (i.e. if it derived its status as a company from the law in force in South Africa because it was incorporated in South Africa), while company B happened to be a national of the Netherlands because it was incorporated in the Netherlands and derived its status as such from the law in the Netherlands. Company B, being a national of the Netherlands would be subject to the shareholders' tax, and would therefore be subject to less favourable tax treatment than the treatment to which a company being a national of South Africa, in the same circumstances, would be subject.

As the sole criterion for the application of the tax was the fact that the shareholder was not incorporated in South Africa (and, therefore, not a South African national), regardless of its residence (i.e. its place of effective management), the regime clearly discriminated on the basis of nationality. In the example given by the Court, all relevant circumstances – including residence – are identical for the subject and object of comparison, apart for their nationality. Since only the subject of comparison was taxed, there was little doubt as to the discriminatory nature of the legislation at issue[165].

b. Court of Appeal 's-Hertogenbosch 13 December 2002[166]

The taxpayer was a company incorporated and having its place of effective management in Switzerland. The taxpayer had a PE in the Netherlands through which it held all the shares in a company that was incorporated in the Netherlands and had its place of effective management in the Netherlands. The taxpayer requested the application of the rules on fiscal unity, as they were in force at the time in the Netherlands. The application of these rules required, among other things, that the companies to be included in the unity were incorporated under the law of the Netherlands and resident in the Netherlands for purposes of Dutch corporate income tax. Because the taxpayer did not fulfill these conditions, the Dutch tax authorities dismissed the taxpayer's request.

---

[164] The Court compares the Dutch/South-African treaty to the South-African/U.K. treaty. The non-discrimination provision of the latter treaty provides that *"nothing contained in this Article shall be construed as obliging either Contracting State to grant to individuals not resident in that State any of the personal allowances and reliefs for tax purposes which are granted to individuals so resident, nor as conferring any exemption from tax in a State in respect of dividends paid to a company which is a resident of the other State."* The Court notes that the treaty with the U.K. thus *"specifically [permits] discrimination in respect of the taxation of dividends"*. This clause was *"deliberately omitted"* from the treaty with the Netherlands, which confirms that the non-discrimination obligation applies to dividends paid to nationals of the Netherlands.

[165] After this judgment, the relevant legislation in South Africa was amended to remove the discrimination, namely by applying the shareholders' tax to all companies whose place of effective management was outside South Africa (see L. KRUGER, "South Africa", in IFA, *Cahiers de droit fiscal international. Non-discrimination at the crossroads of international taxation*, Vol. 93a, Amersfoort, Sdu Fiscale & Financiële Uitgevers, 2008, 531-532).

[166] No. 00/2337, *Vakstudie Nieuws* 2003, 12.2.10.

The taxpayer argued that this amounted to discrimination on the basis of nationality, as prohibited by Art. 10(1) of the 1951 Dutch/Swiss treaty[167]. In a very concise judgment, the Court of Appeal decided in favour of the taxpayer. The Court observed that the fiscal unity regime would have been applicable if the taxpayer was incorporated in the Netherlands, even when its place of effective management was in Switserland. Pursuant to a fiction of domestic tax law, a company incorporated in the Netherlands was considered to be established in the Netherlands for purposes of Dutch corporate income tax, regardless of its place of effective management[168].

Accordingly, the subject of comparison is the taxpayer, a company incorporated in Switzerland and having its place of effective management there, while the object of comparison is a company incorporated in the Netherlands with its place of effective management in Switzerland. As the subject of comparison is denied the benefits of the fiscal unity regime, while these benefits are granted to the object of comparison, the Court decides that the Dutch regime discriminated on the basis of nationality, contrary to Art. 10(1) of the treaty.

IV. Entitlement to Art. 24

The OECD MC's general approach towards the entitlement to treaty benefits is that the treaty provisions *"apply to persons who are residents of one or both of the Contracting States"* (Article 1). In 1977, however, a second sentence was added to Art. 24(1) which states: *"This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States"*[169]. Consequently, being resident in one of the Contracting States is not necessary in order to invoke Art. 24(1). However, nationality non-discrimination clauses that follow the 1963 Draft Convention (and therefore do not contain this statement) cannot be invoked by taxpayers who are not residents of either contracting State, given the general rule in Article 1 that treaty benefits are only available to residents of the contracting States[170]. Since the 1977 OECD MC, that issue is resolved.

[167] Identical to Art. 24(1) of the 1963 OECD Draft Convention.

[168] *"Indien de AG een naar Nederlands recht opgerichte naamloze of besloten vennootschap zou zijn geweest, was die aanvraag van een fiscale eenheid door de werking van de oprichtingsfictie van artikel 2, vierde lid, van de Wet te honoreren geweest, ook wanneer die naamloze of besloten vennootschap – evenals te dezen de AG – feitelijk in Zwitserland gevestigd zou zijn geweest. Door de werking van artikel 2, vierde lid, van de Wet zou die naamloze of besloten vennootschap dan immers geacht worden in Nederland gevestigd te zijn."*

[169] See also Comm. OECD on Art. 24, para. 6: *"The text of paragraph 1 provides that the application of this paragraph is not restricted by Article 1 to nationals solely who are residents of a Contracting State, but on the contrary, extends to all nationals of each Contracting State, whether or not they be residents of one of them. In other words, all nationals of a Contracting State are entitled to invoke the benefit of this provision as against the other Contracting State. This holds good, in particular, for nationals of the Contracting States who are not residents of either of them but of a third State."*

[170] However, some treaties with a nationality non-discrimination clause identical to Art. 24 1963 OECD MC do not contain a provision that restricts the scope of application of the treaty to residents of the contracting States. Under such treaties, it is not required for the application of the non-discrimination clause that the taxpayer is also a resident of one of the States involved. See, for instance, the judgment of the French Conseil d'Etat of 3 March 1993, No. 85626, *Campbell*, *D.F.* 1993, No. 25, Com. 1292, in which the nationality non-discrimination provision of the 1968 French/U.K. treaty was applied to a U.K. national residing in Hong Kong. Similarly, Cour Administrative d'Appel Lyon, 11 June 1991, *Benmiloud*, No. 89LY01921, *D.F.* 1991, No. 43, Com. 2022 (subsequently confirmed in Conseil d'Etat 30 December 1996, *Benmiloud*, No. 128611, *R.J.F.* 2/97, No. 158), in which the nationality non-discrimination provision of the 1968 French/Algerian treaty was applied to an Algerian national residing in Switzerland.

As a result of this addition, nationals of one of the Contracting States who reside in neither of the Contracting States can now invoke the non-discrimination provision of Art. 24(1). An example can clarify this: a national of State A who is a State C resident derives income from State B. As a result of Art. 24(1), this person is entitled to a tax treatment in State B which is neither other, nor burdensome than the tax treatment by State B of State B nationals who do not reside in State B[171]. As an example, see the decision of the Dutch Supreme Court of 14 June 1972, which will be discussed in 2.B.VI.D.b.

The personal scope of Art. 24(1) is limited to the taxpayer himself. Nationality discrimination of other persons who themselves are not liable to tax in the other Contracting State, but who are taken into account in the taxpayer's assessment, does not fall foul of Art. 24(1). For instance, subjecting a tax allowance for a child to the condition that the child is a national of the taxing State, does not constitute a violation of Art. 24(1)[172]. Similarly, Art. 24(1) does not apply to situations where a subsidiary incurs a disadvantage as a consequence of the nationality of its parent company. The *Halliburton*-case of the Dutch Supreme Court illustrates this[173]. Halliburton, an international group with a U.S. incorporated parent and including a wholly owned German subsidiary and a wholly owned Dutch subsidiary, wished to carry out an intra-group reorganisation. In this context, immovable property was transferred from the German subsidiary to the Dutch subsidiary. The transaction did not qualify for the exemption of real estate transfer tax, as this exemption was limited to transfers carried out as part of an intra-group reorganisation between two Dutch companies. As a result, the Dutch subsidiary was liable real estate transfer tax. The taxpayer argued that the restriction of the exemption to Dutch companies constituted discrimination contrary to Article 24(1) of the Dutch/German treaty. The Supreme Court dismissed this argument, noting that Article 24(1) only prohibited distinctions on the basis of taxpayers' nationality. Such a distinction was not made in the Dutch legislation. According to the Supreme Court, Article 24(1) did not offer protection against the 'indirect discrimination' on the basis of the nationality of the Dutch subsidiary's transaction partner[174].

V. The comparability test: 'in the same circumstances'

V.A. On sameness and similarity

In order to apply Art. 24(1), a hypothetical comparison must be made between the subject of comparison and an object of comparison. The comparison must be based on the tax requirements in the **taxing** State, as the rule of Art. 24(1) is a limitation to that State's sovereignty[175]. As a result, the foreign taxpayer's domestic tax treatment is irrelevant in

[171] With regard to the question whether the object of comparison is any State B national who does not reside in State B, or a State B national who resides in State C, I refer to 2.B.II.
[172] K. VOGEL, *On double taxation conventions*, 1997, 1292
[173] Hoge Raad 23 December 1992, no. 27843, *BNB* 1993/71. The case concerned the treaty between the Netherlands and Germany, which, at the time, did not include a provision analogous to Art. 24(5) OECD MC.
[174] It should be noted that the Supreme Court subsequently referred the case to the ECJ to examine the provision's compatibility with the fundamental freedoms (C-1/93, *Halliburton*, 12 April 1994). The ECJ considered the Dutch legislation to constitute 'derivative' discrimination. As a result, it was contrary to the freedom of establishment (see Part III, 2.E.II.C.c; the discrimination was 'derivative' because the disadvantage was not incurred by the protected taxpayer but by his transaction partner).
[175] K. VOGEL, *On double taxation conventions*, 1997, 1297.

assessing whether a discrimination exists[176]. The possibility for the taxpayer to claim an adjustment under domestic law for disadvantages incurred abroad does not remove the discriminatory treatment by the other Contracting State (see also infra, 2.B.VI and Part III, 2.E.I.B).

When making the comparison, the subject of comparison and the object of comparison must be *"in the same circumstances in particular with respect to residence"*. As a result, all relevant factual circumstances (apart from nationality) must be the same. Factors which are irrelevant to the tax measure at issue should not be taken into account[177]. For instance, the position of the French tax authorities that foreigners resident abroad cannot be compared with French nationals resident abroad because French nationals have closer personal and economic ties to France and are more likely to return to France, has been rejected in case law[178]. The 'closer personal and economic ties' of the object of comparison do not render both groups incomparable, as that particular difference is irrelevant to the comparison.

Similarly, the New York Supreme Court for New York County has held that the determination that situations are incomparable must have a 'reasonable basis'[179]. Lufthansa, a German airline which was owned in part by the German government, claimed an exemption from New York City sales and use tax on the basis that it was a government-owned entity, and that the tax authorities had granted similar tax exemptions to the national airlines of other countries. According to the taxpayer, the denial of the exemption violated the non-discrimination provision of the 1954 Treaty of Friendship, Commerce and Navigation between the United States and Germany (Art. XI) which protected nationals of a contracting State from taxation in the other contracting State which is more burdensome than the taxation borne "in like situations" by nationals of any third country[180]. The tax authorities argued that the exemption could be denied because Lufthansa was not fully owned by the German government and was therefore not in a 'like situation' to the other national airlines (which were 100 % government-owned). The Court rejected the administration's argument, by stating that *"ownership of the shares of stock of a foreign corporation is not a reasonable basis upon which to distinguish 'like situations' for tax purposes. […] Total governmental ownership of stock is therefore not a relevant consideration in determining 'like situations' for that purpose."*

It has been argued that the same circumstances-test is redundant, since identity of the relevant circumstances is implied in the very concept of non-discrimination[181]. O'BRIEN has even suggested that the reference to 'same circumstances' only complicates matters and leads to confusion. According to that author, a more sensible approach would be *"to abandon the similar circumstances test altogether and instead require for nondiscrimination protection only that the alien be a resident of [the taxing State]. This test would have the advantage of simplicity and predictability, which is lacking under the similar circumstances test. In*

[176] Furthermore, the fact that only the tax treatment in the taxing State is taken into account, obviously means that the mere difference in taxation between two States cannot amount to discrimination.
[177] See also infra, 2.B.VIII, *"Comparability as a safety valve?"*
[178] Tribunal administratif de Nice 3 August 1988, *RJF* 1/89, no. 54, referred to in K. VOGEL, *o.c.*, 1296, No. 37.
[179] Supreme Court, New York County, New York, 12 January 1976, *Deutsche Lufthansa AG v. City of New York*, 379 N.Y.S.2d 635.
[180] Although it concerned a most favoured nation-clause in Treaty of Friendship, Commerce and Navigation, and not a non-discrimination provision in a tax treaty, the decision is relevant, as it deals with the interpretation of the phrase 'in like circumstances' which is an older form of 'in the same circumstances' and as such a predecessor of the wording currently used in the OECD MC.
[181] K. VAN RAAD, *o.c.*, 88.

addition, it would be consistent with, and a reasonable interpretation of, most existing treaties, which contain the term 'resident' but make no mention of similar circumstances."[182]

This argument is based on the assumption that residence is the only relevant consideration in the application of the non-discrimination provision. However, other circumstances may be relevant as well[183] (see, for instance, 2.B.VI.D.b, on the Dutch Supreme Court case of 14 June 1972, where qualification as a frontier worker was relevant as well[184]). Thus, replacing the similar circumstances test with a simple residence test might simplify matters, but it would also erode the non-discrimination provision.

The OECD Commentary states that the expression 'in the same circumstances' refers to taxpayers placed, from the point of view of the application of the ordinary taxation laws and regulations, **in substantially similar circumstances both in law and in fact**. This might seem odd, as the text of the MC requires the circumstances to be **the same**, which implies equality; not mere similarity[185]. The French version of the Commentary, which refers to *"des circonstances de droit et de fait analogues"* seems to deviate even more from the requirement of sameness imposed by the MC[186]. As AVERY JONES points out, the Commentary, in referring to similar rather than identical circumstances, intended to prevent arguments about minor differences in circumstances[187]. The reference to 'similar circumstances in fact', however, has enabled tax authorities to argue that taxpayers are not placed in the same (i.e. substantially similar) factual circumstances. The 'closer personal and economic ties' in the argument of the French tax authorities mentioned above are an example of such irrelevant factual circumstances.

It would be better to require the circumstances to be identical (instead of similar) in fact: in that case, a comparison must be made between the foreign taxpayer and a hypothetical national taxpayer in identical factual circumstances[188]. As mentioned, it might be argued that

---

[182] J. O'BRIEN, *o.c.*, 560-561.

[183] The OECD Commentary to Art. 24 gives two examples in paras. 10-12. The first example concerns public bodies and services: *"if a State accords immunity from taxation to its own public bodies and services, this is justified because such bodies and services are integral parts of the State and at no time can their circumstances be comparable to those of the public bodies and services of the other State."* An exception is made for State corporations carrying on gainful undertakings. The second example concerns private institutions not for profit whose activities are performed for purposes of public benefit, which are specific to that State: *"if a State accords taxation privileges to [such institutions], this is clearly justified by the very nature of these institutions' activities and by the benefit which that State and its nationals will derive from those activities."* As VAN RAAD argues, the institutions referred to in the latter example might include private pension funds (K. VAN RAAD, *o.c.*, 90). See also infra, 2.B.VIII, on the question whether the same circumstances-test might function as a safety valve.

[184] Also, in order to be in the same circumstances with respect to residence in that case, the object of comparison had to be a resident of Belgium; a resident of the taxing State (the Netherlands) would not be in the same circumstances as the subject of comparison.

[185] Cf. the Wellington Court of Appeal in *Commissioner of Inland Revenue v. United Dominions Trust Limited* (1973) 1 NZTC 61,028: *"The word 'same' carries the connotation of uniformity, of exactness in comparison. The phrase does not ordinarily mean in roughly similar circumstances: it means in substantially identical circumstances, and in [the nationality non-discrimination provision] it means in substantially identical circumstances in all areas except nationality."*

[186] The 2008 update to the Comm. OECD on Art. 24 states in para. 3 that, despite the different wording, there is only one comparability-test throughout Art. 24 OECD MC: *"The various provisions of Article 24 prevent differences in tax treatment that are solely based on certain specific grounds (e.g. nationality, in the case of paragraph 1). Thus, for these paragraphs to apply, other relevant aspects must be the same. The various provisions of Article 24 use different wording to achieve that result (e.g. 'in the same circumstances' in paragraphs 1 and 2; 'carrying on the same activities' in paragraph 3; 'similar enterprises' in paragraph 5)."*

[187] J. AVERY JONES, *et al.*, "The non-discrimination article in tax treaties", *European Taxation* 1991, 312.

[188] J. AVERY JONES, *et al.*, *o.c.*, 313.

demanding equality would lead to endless arguments about minor differences in circumstances. Minor differences in circumstances, however, can also be relevant to the taxation. One should rather be concerned with arguments about differences which are **irrelevant**. The decisive question should therefore be whether the circumstances which are relevant for the taxation are identical[189]. Moreover, requiring the circumstances to be relevant for the taxation might also solve issues that, at first sight, seem to constitute indirect discrimination. As indicated above, Art. 24(1) OECD MC is only concerned with discrimination 'on the basis of' nationality. That could be interpreted as allowing States to impose conditions which, in practice, primarily exclude foreigners from tax benefits without expressly referring to nationality. Assume, for instance, that State A imposes a tax less favourably on people with a certain skin colour. If none of the nationals of State A have that skin colour, while all of the nationals of State B do, the tax discriminates 'indirectly' on the basis of nationality. However, if Art. 24(1) is interpreted strictly, it would not prohibit such discrimination as no reference to nationality is made. This would be avoided by interpreting the same circumstances test as requiring all relevant characteristics to be identical. Skin colour is irrelevant to the taxation, and would thus be ignored when making the comparison. Consequently, State A and State B nationals are in the same circumstances, and the non-discrimination provision prohibits taxation of State B nationals which is more burdensome than the taxation of State A nationals.

In addition to the factual circumstances, a comparison of the taxpayer's **legal responsibilities** must be made. For instance, a U.S. national who is not a U.S. resident continues to be subject to worldwide income taxation under U.S. tax law. Such a U.S. national is not in the same circumstances as a national of the other contracting State who is not a U.S. resident and consequently subject to limited tax liability in the U.S. In other words, the difference in the scope of tax liability is, at first sight, a relevant difference in circumstances. The U.S. Model Convention expressly addresses this issue by adding a third sentence to Art. 24(1): *"However, for the purposes of United States taxation, United States nationals who are subject to tax on a worldwide basis are not in the same circumstances as nationals of* -------- *who are not residents of the United States."*

In the Commentary to the OECD MC, an observation in the same vein is made[190]: *"The United States observes that its non-resident citizens are not in the same circumstances as other non-residents, since the United States taxes its non-resident citizens on their worldwide income."* To give effect to this observation, the third sentence of Art. 24(1) U.S. MC is sometimes included in the nationality non-discrimination provision of tax treaties concluded by the US[191]. Consequently, such a non-discrimination provision does not apply to nationals of the other Contracting States who do not reside in the US.

It is clear that the comparison of the legal circumstances might prove to be difficult if one assumes that differences caused by nationality must be ignored[192]. Indeed, the differences in legal circumstances may be inextricably linked to the differences in nationality. The situation

[189] Similarly, B. SANTIAGO, "Non-discrimination provisions at the intersection of EC and international tax law", *European Taxation* 2009, 256.
[190] Comm. OECD on Art. 24, para. 62.
[191] E.g. the 2006 treaty with Belgium, the 1997 treaty with Ireland and the 1992 treaty with the Netherlands.
[192] As nationality is exactly the basis of differentiation, and consequently must be ignored in order to assess whether the circumstances are the same, all differences caused by nationality must also be ignored. It would indeed be contradictory to refer to differences between the subject and object of comparison which are direct consequences of the difference in nationality in order to argue that the situations are incomparable. See also Part I, B, on characteristics that are inherent in the comparative attribute.

of non-resident U.S. nationals referred to above illustrates this point: the different legal circumstances (limited or full tax liability) are inextricably linked to the differences in nationality. If one assumes that these differences must be ignored when assessing whether nationality discrimination occurs, the third sentence of Art. 24(1) U.S. MC and the U.S. observation on Art. 24(1) OECD MC would be redundant. It has been argued that the Commentary, in stating that the circumstances must be substantially similar both in law and in fact from the point of view of the application of the ordinary taxation laws and regulations, implies that if no hypothetical taxpayer can be construed to make the comparison (in casu because the legal circumstances are too different), the comparison should not be attempted[193]. For instance, in cases where nationals of a State are taxed as residents (e.g. in the U.S.), the comparison between a national non-resident and a non-national non-resident cannot be made. In order to make the comparison, a hypothetical taxpayer in the same circumstances must be construed, whereby 'in the same circumstances' refers in particular to the hypothetical national taxpayer being taxed as a non-resident. As, in the example, nationals of State A are by definition taxed as residents, no such hypothetical national taxpayer can be construed[194]. The New Zealand case and the Belgian case examined below support this position[195].

However, VAN RAAD is of the opinion that, as the nationality non-discrimination provision eliminates nationality as a possible ground for differential treatment, all the consequences flowing from the difference in nationality must also be covered by the provision[196]. As a result, if State A taxes its nationals on their worldwide income in the same way as residents (as the U.S. does in the example given above), a State A national who is resident in State B and taxable as a resident of State A (full tax liability in State A as a result of State A nationality) is in the same circumstances as a State B national who is resident in State B and taxable in State A as a non-resident (limited tax liability in State A). The difference in tax liability, flowing from the difference in nationality, should be treated in a non-discriminatory manner as well, which means that State A is prohibited from treating both taxpayers differently. The U.S. seems to agree with VAN RAAD's interpretation, given the inclusion of the above mentioned third sentence in Art. 24(1) U.S. MC and the observation on Art. 24(1) OECD MC. This interpretation may have far-reaching consequences. If the general principle

[193] J. AVERY JONES, *et al.*, *o.c.*, 314.

[194] If reverse discrimination is possible under Art. 24(1) (see infra), it might be argued that State A is merely applying reverse discrimination by using nationality as the sole criterion for taxation in State A. By not taxing State B nationals on their worldwide income, State A is merely granting State B nationals more favourable treatment, which is permitted under Art. 24(1). This would mean that the comparison between State A nationals and State B nationals is possible, and that – following application of Art. 24(1) – State A should extend all benefits given to its own nationals to State B nationals. The observation made by the U.S. on Art. 24 (cf. supra) could be understood to support this position, by confirming that it does not tax non-resident foreign taxpayers on their worldwide income, as opposed to non-resident nationals. However, this is unlikely. The U.S. observation is probably made to avoid having to extend benefits to foreign taxpayers, by stressing the incomparability of their situation (cf. also J. AVERY JONES, *et al.*, *o.c.*, 326). Furthermore, I will argue below that the possibility of reverse discrimination under Art. 24(1) is limited to the formalities connected with the taxation. The taxation itself, the basis of charge, the rates, etc. are governed by the principle of equal treatment (meaning that reverse discrimination is impossible). So the fact that State B nationals are not taxed on their worldwide income, while State A nationals are, cannot be explained by reference to reverse discrimination.

[195] See also the decision of the German Bundesfinanzhof of 30 April 1975, no. I R 41/73, *BStBl* 1975, II, 706, and discussed in X., "German-Swiss and German-UK tax treaties: reorganization of limited partnership into limited liability company; taxation of hidden reserves", *European Taxation* 1976, 164. The court decided that the non-discrimination provision of the applicable tax treaty did not require that rules which applied to persons subject to full tax liability should also be applied to persons subject to limited tax liability, since they are not in the same circumstances.

[196] K. VAN RAAD, *o.c.*, 91; K. VAN RAAD, "Netherlands withholding tax on dividends paid to foreign parent companies and nondiscrimination clauses?", *Intertax* 1982, 187.

that nationality should not serve as a basis for differences in tax treatment is strictly applied, one could indeed argue that attaching the difference between limited and unlimited tax liability (and all the consequences thereof) to nationality constitutes a form of prohibited nationality discrimination. This, however, would imply that the very core of tax regimes such as the U.S. regime, basically violate most tax treaties (barring possible reservations, such as those inserted by the U.S.).

Thus, the issue boils down to the contradiction between two basic elements of the nationality non-discrimination concept: the requirement that the relevant legal circumstances must be the same on the one hand, and the prohibition of different tax treatment on the basis of nationality on the other hand. First of all, the scope of tax liability is generally a relevant legal circumstance when assessing whether tax discrimination occurs. Consequently, if the scope of tax liability differs among the subject and object of comparison, the comparison should not be attempted. It is possible, however, that the different scope of tax liability is inextricably linked with nationality. If we tip the balance in favour of the first element (the sameness requirement) then such situations are impossible to test against a nationality non-discrimination provision. The second principle is that tax treatment must not differ on the basis of nationality. As a result, all the consequences flowing from the differences in nationality must not give rise to a difference in tax treatment either. If a legislator is prohibited from attaching burdensome tax consequences to non-nationality, he should also be prohibited from attaching burdensome tax consequences to a factor which was introduced by the legislator himself in order to substitute nationality. If one is prohibited from attaching burdensome taxation to characteristic X, the logical consequence of this prohibition should be that one is prohibited as well from granting treatment Y to everyone having characteristic X[197] and subsequently attaching burdensome taxation to everyone receiving treatment Y. If that were to be allowed, every non-discrimination provision could be evaded simply by renaming the characteristic which should receive non-discriminatory treatment. The argument set out above, i.e. that all relevant legal circumstances must be the same in order to make the comparison, can be countered by holding that nationality must be ignored when making the comparison[198]. Therefore, all consequences flowing from nationality must be ignored as well. This would mean that the difference in scope of tax liability, being a direct consequence of nationality, cannot be invoked as a difference in legal circumstances which would render the comparison impossible.

The 2008 update of the Comm. OECD has addressed this issue by stating that *"the expression 'in the same circumstances' can in some cases refer to a person's tax situation. This would be the case, for example, where a country would subject its nationals, or some of them, to a more comprehensive tax liability than non-nationals (this, for example, is a feature of the United States tax system). As long as such treatment is not itself a violation of paragraph 1, it could not be argued that persons who are not nationals of that State are in the same circumstances as its nationals for the purposes of the application of the other provisions of the domestic tax law of that State with respect to which the comprehensive or limited liability to tax of a taxpayer would be relevant (e.g. the granting of personal allowances)"*[199].

---

197 Leaving aside the question whether this treatment Y itself is already burdensome.

198 Nationality is the object of the nationality non-discrimination clause. Obviously, one cannot expect the 'same circumstances' requirement to cover nationality as well, as this would render a nationality non-discrimination provision entirely void.

199 Comm. OECD on Art. 24, para. 9. In OECD, "Application and interpretation of Article 24 (non-discrimination). Public discussion draft", 3 May 2007, 13, it is stated that *"there is some uncertainty as to what are the relevant factors in determining whether taxpayers are in the same circumstances for purposes of paragraph 1. Paragraphs 3 to 8 of the Commentary on Article 24 provide that the phrase refers to taxpayers*

Thus, the Commentary chooses to tip the balance in favour of the requirement that all circumstances must be the same. However, three observations are in order. First of all, the Commentary only addresses the situation where the nationality of taxpayers determines the scope of their tax liability. In such a case, Art. 24(1) is not violated, as the circumstances are not the same according the Commentary. This does not mean, however, that States are free to attach random legal consequences to the factor nationality, and subsequently attach favourable or detrimental tax treatment to those legal consequences (thereby avoiding the nationality non-discrimination principle by simple substitution, cf. supra).

Secondly, the statement in the Commentary is only valid as long as *"such treatment"* (i.e. the person's tax situation) *"is not itself a violation of paragraph 1"*. This means that the different tax situation which is linked with the taxpayer's nationality and which is relied on to argue that the situations are incomparable, must not be discriminatory in itself. But that observation does not really add anything to the analysis. If a State attaches discriminatory consequences to nationality, it is clear that there is an infringement of Art. 24(1). That is precisely what Art. 24(1) prohibits.

Finally, the statement is only valid *"for the purposes of the application of the other provisions of the domestic tax law of that State with respect to which the comprehensive or limited liability to tax of a taxpayer would be relevant (e.g. the granting of personal allowances)"*. This confirms, once again, that the mere existence of a difference between two situations (in the present case, the different scope of tax liability) is not sufficient to render them incomparable. It is necessary that the difference is **relevant** from the perspective of the measure at issue. For instance, it could be said that the scope of tax liability is relevant from the persepective of domestic tax measures that take account of the taxpayer's personal and family circumstances. That is to say, if one assumes that a taxpayer's ability to pay in a given State is reflected by his scope of tax liability in that State, then that scope of tax liability is certainly relevant from the perspective of domestic measures that grant benefits in order to take account of taxpayers' personal ability to pay tax[200]. On the other hand, it may be possible that the taxpayer's scope of tax liability is irrelevant for the domestic meausre under scrutiny, for instance where a domestic measure is solely intended to prevent double taxation on dividends. From the perspective of such a measure, it is irrelevant whether a taxpayer is subject to full tax liability or not.

Reported case law interpreting the expression 'in the same circumstances' generally applies the approach chosen by the 2008 update, i.e. that the difference in tax liability is a relevant circumstance to be taken into account, even if that difference is caused by a difference in nationality. From a conceptual perspective, however, it is difficult to accept that characteristics which are inherent in the comparative attribute can render the situations incomparable. Such characteristics may come up for discussion in the justification-test (see Part III, 2.F.III), but there is broad agreement that Art. 24 OECD MC does not allow for justification-grounds (see, however, Part IV, 1.B).

---

who are placed, from the point of view of the application of the ordinary taxation laws and regulations, in "substantially similar circumstances" both in law and in fact. The term "substantially" is somewhat unclear, although paragraph 1 provides expressly that a resident and a non-resident are not in the same circumstances. […] The Working Group noted that changes made under other issues would provide some clarification on the meaning of the phrase "in the same circumstances". It agreed, however, to clarify that taxpayers with limited tax liability are usually not in the same circumstances as taxpayers with unlimited tax liability."

[200] On this point, see also the discussion of the ECJ's *Schumacker*-case law in Part III, 2.E.I.A.b.1.

V.B. Case law

a. Leeuwarden Court of Appeal 7 April 2000[201]

This is a very simple case to illustrate how the comparability-test functions in practice. The taxpayer was a national and resident of the Netherlands who was employed aboard a Danish ship engaged in international traffic. The salary paid by his employer, a Danish shipping company, was only taxable in the Netherlands under Art. 17 of the 1957 Danish/Dutch tax treaty.

In Danish domestic tax law, taxpayers employed aboard a Danish ship were exempt from tax in Denmark as regards remuneration received for this employment. This measure was introduced in order to improve Denmark's competitive position and to prevent shipping companies from relocating to low-tax jurisdictions. After negotiations, the trade union and the employer's organizations agreed that the benefit resulting from the Danish measure (i.e. the tax formerly due on the remunerations) would go to the Danish shipping companies, by lowering the salaries from gross to net. As a result, the salaries paid to Danish employees, who came under the scope of the Danish income tax, did not change (the wage tax applicable before the introduction of the measure now went to the employer instead of to the Danish treasury). However, salaries paid to non-resident employees of Danish shipping companies, which were not subject to tax in Denmark, were significantly lower as a result of the measure.

The taxpayer objected against his assessment in the Dutch individual income tax on the basis of the nationality non-discrimination provision of the 1957 Danish/Dutch tax treaty[202]. He argued that Danish nationals working aboard a Danish ship were treated more favourably as they were not taxed on their salaries. Apparently, the taxpayer makes the comparison between Dutch nationals resident in the Netherlands and Danish nationals resident in Denmark. Obviously, this line of reasoning is incorrect. The comparison should be made between Dutch nationals who are residents of the Netherlands (subject of comparison) and Danish nationals who are also residents of the Netherlands (object of comparison). There is no difference in treatment between these categories of taxpayers: both are exempt from tax on their salaries in Denmark, and liable to tax on those salaries in the Netherlands. The Court therefore correctly decides that no discrimination arises, as Dutch tax law did not treat comparable situations differently[203].

b. United Dominions Trust Ltd[204]

This case illustrates the issues referred to above, where the criteria for determining nationality and residence overlap. The taxpayer, United Dominions Trust Ltd., was a company incorporated and carrying on business in the U.K. It did not have a place of business in New Zealand, nor did it conduct any operations there. The U.K. company held four-fifths of the share capital of a New Zealand company.

[201] Hof Leeuwarden 7 April 2000, No. 98/1310, *Vakstudie Nieuws* 2000/36.5.

[202] Art. 26(1) of the treaty: *"The nationals of one of the States shall not be subjected in the other State to any taxation or any requirement connected therewith which is other, higher or more burdensome than the taxation and connected requirements to which nationals of the latter State under similar circumstances are or may be subjected."*

[203] *"Een – in verdragsbepalingen opgenomen – vorm van discriminatie is niet aan de orde. Er is immers geen sprake van gelijke gevallen die beide onder de werking van de Nederlandse (belasting)wetgeving ongelijk worden behandeld."*

[204] Wellington Court of Appeal, *Commissioner of Inland Revenue v. United Dominions Trust Limited*, 16 July 1973 (1973) 1 NZTC 61,028.

The New Zealand company paid interest to the U.K. company. The New Zealand tax authorities imposed tax on the interest at the non-resident rate. New Zealand tax rates were different for companies that were 'deemed to be resident in New Zealand' and companies that were not 'deemed to be resident in New Zealand'. A company was 'deemed to be resident in New Zealand' if it (a) was incorporated in New Zealand or (b) had its head office in New Zealand. Accordingly, the U.K. taxpayer was not deemed to be resident in New Zealand and it was therefore subject to the higher tax rate. The taxpayer argued that the fact that it was assessed at a higher rate than a company resident in New Zealand would have been on that income fell foul of the nationality non-discrimination clause of the New Zealand/U.K. tax treaty[205].

A company incorporated in New Zealand was a national for purposes of the tax treaty[206]. For domestic New Zealand tax purposes, such a company could never be considered to be resident outside New Zealand, regardless of the location of its management or its operational activities, since incorporation in New Zealand was enough for a company to be deemed to be resident in New Zealand (see supra). As a result, a company of New Zealand nationality (incorporation) was always entitled to the lower rate of taxation, whereas a company of U.K. nationality (incorporation) which was resident outside New Zealand was always taxed at the higher rate.

The taxpayer tried to demonstrate that the difference in residence was really a difference in nationality, by comparing the U.K. company to a New Zealand company which is equal to it in every respect, except that it is incorporated in New Zealand (so the hypothetical company is a company incorporated in New Zealand with its management and operations in England). According to the taxpayer, the only pertinent difference between the two companies is their nationality. Therefore, the nationality non-discrimination provision should apply.

The Court, however, dismisses this argument. The Court starts by addressing the overlapping (and possibly conflicting) concepts of residence and nationality of companies: *"The question remains whether one can distinguish so simply and completely between the concepts of nationality and residence for the purposes of the Agreement. I do not think one can. […] It is not disputed that the purpose of para. (1) is to prevent discrimination on the grounds of nationality, but, I must stress, only when the circumstances upon which taxation is based are the same between the two being compared. [...] The important words in deciding the first issue are 'in the same circumstances'. The word 'same' carries the connotation of uniformity, of exactness in comparison. The phrase does not ordinarily mean in roughly similar circumstances: it means in substantially identical circumstances, and in Art XIX(1) it means in substantially identical circumstances in all areas except nationality. Can then the difference in residence be accepted in this case as a valid basis for applying a different tax rate or must nationality be seen as the true basis of the distinction made? These two terms, residence and nationality, and especially the latter, are treacherous words for they are somewhat artificial when applied to corporate bodies. But in the Agreement I find strong recognition of the importance of the concept of residence as the source of taxing power and of the right of contracting parties to impose different rates or conditions of tax on companies according to residence"*[207].

[205] Art. XIX (1) of the 1966 New Zealand/U.K. treaty, which is identical to Art. 24(1) 1963 OECD MC, except that it does not prohibit 'other' taxation.
[206] Art. II (1)(i)(ii) of the 1966 New Zealand/U.K. treaty.
[207] Wellington Court of Appeal, *United Dominions Trust Limited* (1973), para. 20-22.

The comparison made by the taxpayer with a hypothetical company incorporated in New Zealand with its management and operations in England did not persuade the Court: *"I do not find the hypothetical example of the company incorporated in New Zealand but, in fact, located and trading overseas [...] as an obstruction to the prominence I give the matter of residence when determining whether it can fairly be said that the discrimination in this case was based on nationality. It is true that the only difference between the hypothetical company and the respondent is the former's birth in this country, but birth is not an unimportant factor to be taken into account in prescribing a test of residence for companies. If a company obtains its existence and status wholly by virtue of the law of the country in which it was incorporated, it seems to me supportable, both as a matter of justice and on recognized tax practice, to base residence on the fact of incorporation. New Zealand has chosen to do that, and I think it is a little superficial to say, in such circumstances, that the essential substance of the difference between the two companies is a matter of nationality and not residence. It should not be overlooked that the test of residence can be of advantage to a company incorporated in the United Kingdom which as a result of having its centre of administrative management in New Zealand and not in the United Kingdom is taken [...] to be resident in this country and entitled to be assessed at the lower rate, whereas another company of the same birth but resident in the United Kingdom must be assessed at the higher rate."*[208] The Court therefore concludes that the distinction was really on the basis of residence, not nationality. Consequently, the taxpayer was not 'in the same circumstances' as a company resident in New Zealand.

Thus, the Court recognizes that the overlapping of residence and nationality of companies in New Zealand may lead to conflicts. It cannot be denied that non-national companies, such as the U.K. company in casu, are discriminated against. On the other hand, it must also be admitted that the U.K. company is not in the same circumstances with respect to residence as a company incorporated in New Zealand. In the estimation of the Court, the balance should tip in favour of the concept of residence as the source of taxing powers of States and the basis for differentiation of, for instance, tax rates. This approach should be approved of. It clearly follows from the wording of Art. 24 OECD MC that nationality discrimination is only prohibited in cases where the taxpayer is in the same circumstances with respect to residence as a hypothetical national taxpayer[209]. In order to make the comparison in casu, a the object of comparison is a hypothetical company that is at the same time a national of New Zealand and a non-resident of New Zealand. As indicated above, such a hypothetical company cannot exist. Consequently, it cannot be said that there was discrimination contrary to the nationality non-discrimination clause.

c. Belgian Supreme Court 30 June 1988[210]

The Belgian Supreme Court reached a similar conclusion in a case concerning Art. 25 of the 1964 Belgian/French treaty (a nationality non-discrimination provision identical to Art. 24(1) 1963 OECD MC). The PE of a company incorporated in France could not enjoy certain benefits when it received dividends, since those benefits were only available to resident

[208] Wellington Court of Appeal, *United Dominions Trust Limited* (1973), para. 23-24.
[209] It should be mentioned that the 1966 New Zealand/U.K. treaty was based on the 1963 OECD MC, and thus did not include the expression 'in particular with respect to residence'. However, the Court considered that 'same circumstances' included 'residence': Wellington Court of Appeal, *United Dominions Trust Limited* (1973), para. 42, 44-45.
[210] Cass. 30 June 1988, *F.J.F.* 1988, 88/202.

companies[211]. It must be stressed that the applicable treaty did not contain a provision corresponding to Art. 24(3) OECD MC[212]. The treaty did offer some protection to Belgian PEs of foreign companies in Art. 17(3), but this provision deviated significantly from Art. 24(3): *"The profits which companies resident in France with a permanent establishment in Belgium realise there shall be subject in that latter State to the system of taxation applicable to similar foreign companies."*

Before the Brussels Court of Appeal, the French company submitted that the more burdensome taxation in Belgium amounted to a form of nationality discrimination prohibited by Art. 25 of the treaty. The tax administration countered by stating that Art. 25 was not applicable, as Art. 17(3) governed the situation. The Brussels Court of Appeal[213] held that Art. 17(3) had to be interpreted in a way that made it compatible with the non-discrimination clause of Art. 25. Consequently, the French company with a PE in Belgium had to be guaranteed the same tax treatment as a Belgian company in the same circumstances with regard to exemptions and reductions of taxes[214].

The Supreme Court rejected this reasoning. Unlike Art. 24(3) OECD MC, Art. 17(3) of the Belgian/French treaty does not grant national treatment to PEs of foreign companies. The provision only grants MFN treatment to such foreign companies. In other words, Belgian PEs of French companies are not assimilated to Belgian companies. Rather, French companies with a Belgian PE are assimilated to other foreign companies with a Belgian PE. As a result, the Belgian domestic rule which limited tax benefits to resident companies did not fall foul of Art. 17(3), since all non-resident companies were excluded.

As indicated earlier, the basic mechanism underlying an MFN clause is the same as the mechanism governing a non-discrimination provision (or an equal treatment-provision): a State must not treat one group of persons less favourably than another group of persons (or a State must treat both groups equally). The difference lies in the object of comparison. Where a nationality or residence non-discrimination (or equal treatment) provision refers to the treatment given to nationals or residents, the MFN clause refers to the treatment given to subjects of a third State. Thus it would seem that, in the case at hand, the French company could have invoked the MFN clause in order to obtain the benefits of a tax treaty concluded by Belgium with a third State, which contains a provision similar to Art. 24(3) OECD MC. Suppose, for instance, that the Belgian/U.K. treaty at the time contained a provision identical to Art. 24(3) OECD MC. Considering on the one hand the fact that under the Belgian/U.K. treaty the Belgian PE of a U.K. company should be assimilated with a Belgian company, and on the other hand, that under Art. 17(3) of the Belgium/France treaty the Belgian PE of a French company should not be treated less favourably than the PE of a U.K. company, one could argue that the Belgian PE of the French company is entitled to national treatment in Belgium as well. As indicated above, however, tax treaties are, by their very nature, reciprocal (see also infra 2.B.VII, on reciprocity). A concession made in a tax treaty by a contracting State is inextricably linked with the concessions made by the other State, and is by its very nature restricted to the two States parties to the treaty. As a result, such a concession cannot

[211] The Belgian regime at issue will be discussed in more detail in 2.D.II.B.a.2.
[212] On the relationship between Art. 24(1) and (3), see 2.H.I.
[213] Brussels Court of Appeal 13 January 1987, *J.D.F.* 1987, 232.
[214] *"L'Article 25 de la convention ne peut signifier d'autre qu'une société française, ayant un établissement stable en Belgique, peut faire valoir les mêmes droits quant aux exonérations et exemptions des impôts que ceux dont bénéficient les sociétés belges se trouvant dans la même situation"*. See also P. VERJANS, "Permanent establishments of foreign companies entitled to equal treatment as Belgian companies in the field of tax credit", *European Taxation* 1988, 86-88.

be extended to a resident of a third State on the basis of a non-discrimination clause in the treaty between that third State and one of the contracting States in question.

With regard to the general nationality non-discrimination provision of Art. 25 of the treaty, the Supreme Court held that the French company was not in the same circumstances as a Belgian company: by reason of their residence in Belgium, Belgian companies were subject to full tax liability (corporate income tax), while French companies were only subject to limited tax liability (non-residents' income tax). As a result, there was no prohibited nationality discrimination.

It has been argued that the Supreme Court's decision is based on a circular argument, as the Court justifies the different tax treatment of the French company by referring to the different tax regime to which the French company is subject in Belgium[215]. The French company is a non-resident in Belgium, which means it is subject to the non-residents' income tax. Belgian companies, on the other hand, are subject to corporate income tax. Referring to the difference in applicable tax regimes to explain why different tax regimes apply might indeed seem to be a form of circular reasoning at first sight, but this is not the case. In this respect, reference should be made to what has been said above about the difference between residence as the basis for tax liability and nationality as a prohibited criterion of differentiation. Companies resident in Belgium are, by reason of their residence, subject to unlimited tax liability, while companies resident abroad are subject to limited tax liability. Distinguishing on that basis is not the same as introducing a difference in tax treatment between companies based on their nationality.

d. The Anglo-Swiss Land and Building Company Ltd.[216]

a. The Supreme Court's decision

The French Supreme Court's decision of 28 February 1989 seems to contrast with the case law discussed above: the facts of the case are similar to those of the Belgian and New Zealand case, but the Court nevertheless considers the comparison to be possible.

The French Finance Act of 1983 introduced an annual tax of 3% of the market value of real property owned by companies having their 'seat' outside France (*"les personnes morales dont le siège est situé hors de France"*)[217]. The word 'seat' should be interpreted as 'central administration', or 'real seat' in this context, since the Act uses 'siège' without any of the qualifications which are sometimes used, such as 'siège social' (registered office) or 'siège statutaire' (statutory seat)[218]. The real seat is the place where the company is managed, where the actual decisions are taken[219], where the main contracts are signed or where the board of directors and shareholder meetings are held[220]. Under French Corporate Law applicable at the time, companies whose registered office ('siège social') was located in France were subject to French law. Furthermore, third parties (e.g. the tax administration) were allowed to rely on the

---

[215] A. HAELTERMAN, "Cass. 30 June 1988 (case note)", *A.F.T.* 1989, 47

[216] Cour de Cassation 28 February 1989, No. 87-14900, *D.F.* 1989, No. 19, Com. 943.

[217] Art. 4 (II) (1) Law no. 82-1126 of 29 December 1982, *Official Gazette* 30 December 1982. The tax did not apply to companies having their seat in States with which France has concluded a tax treaty containing an administrative assistance clause for the prevention of tax fraud and tax evasion (if those companies fulfilled certain formal requirements). The French/Swiss treaty, which is at issue here, did not contain such a clause.

[218] J. AVERY JONES, *et al.*, *o.c.*, 315; H. LAZARSKI, "Real property owned by foreign companies – present position resulting from publication of new ruling", *European Taxation* 1983, 279.

[219] A. CHARVERIAT and A. COURET, *Sociétés commerciales*, Paris, Lefebvre, 2004, 138.

[220] H. LEHERISSEL, "France. The tax residence of companies", *European Taxation* 1999, 158.

registered office laid down in the company's statutes (i.e. the company's by-laws and articles of incorporation) but that registered office could not be invoked by the company if the 'real' seat was located elsewhere[221].

A company incorporated in Switzerland that had its real seat in Switzerland submitted that the 3% real property tax amounted to a form of nationality discrimination contrary to the French/Swiss tax treaty[222]. The tax administration argued that the criteria for the application of the 3% tax were based on notions independent of nationality. Moreover, companies whose registered offices are in Switzerland (i.e. Swiss nationals) and who are subject to the 3% tax are not in the same circumstances as companies whose registered offices are in France (i.e. French nationals).

The Supreme Court read the tax treaty definition of 'nationality'[223] together with the domestic provision stating that companies having their registered office in France were subject to French law. The interplay of these two provisions led the Supreme Court to the conclusion that the criteria for the application of the 3% tax to companies having their seat outside France must take into account not only their status as non-residents of France, but also necessarily their ties to a State other than France. According to the Supreme Court, companies owning French real property are in the same circumstances for the purposes of the tax at issue, regardless of the location of their seat. In other words, with regard to the comparison that must be made under the nationality non-discrimination provision, the question whether the seat is located in France or in Switzerland is of no relevance as both companies are in the same position from both a legal and factual point of view[224].

The Supreme Court thus holds that the disputed regime amounted to nationality discrimination. In the light of what has been said above, this may seem odd. It has been argued that the Supreme Court would have reached a different conclusion if the disputed regime referred expressly to the place of effective management of the company owning real property in France, instead of referring to the 'seat' ('siège'). In that case, it might have been easier for the tax administration to argue that the difference in treatment was not based on nationality, but rather on residence[225]. This, of course, raises the question to the exact meaning of 'seat', if it is not synonymous with 'place of effective management'. Furthermore, the wording of the Supreme Court is rather obscure (e.g. what is meant by the statement that

[221] Art. L210-3 Code de Commerce.
[222] See Art. 26(1) of the 1966 French/Swiss treaty, which follows Art. 24(1) 1963 OECD MC.
[223] Art. 26(2) of the 1966 treaty, which follows Art. 24(2) 1963 OECD MC.
[224] The paragraph in which the Court sets out this reasoning reads as follows: *"Mais attendu, d'une part, que l'article 26 de la Convention […] indique, en son paragraphe 2, que le terme 'nationaux' désigne pour chaque Etat contractant toutes les personnes morales constituées conformément à la législation dudit Etat, tandis que l'article 3 de la loi du 24 juillet 1966 dispose que les sociétés dont le siège social est situé en territoire français sont soumises à la loi française; qu'il résulte de la combinaison de ces textes que le critère tiré par l'article 990 D du Code général des impôts, pour délimiter son champ d'application, de la localisation hors de France du siège des sociétés concernées se réfère non seulement à leur qualité de nonrésident français mais aussi nécessairement à leur rattachement à un Etat autre que la France; Attendu, d'autre part, qu'eu égard au fait générateur de la taxe instituée à l'article 990 D du Code général des impôts, se trouvent dans la même situation au sens de l'article 26 précité, c'est-à-dire sont placées dans les mêmes circonstances de droit et de fait au regard de l'application de la législation fiscale française de droit commun, des sociétés possédant des immeubles situés en France, la localisation de leurs sièges, en France pour les unes et en Suisse pour les autres, étant sans influence sur la comparaison qu'il y a lieu d'effectuer; Attendu, dès lors, […] qu'en application des dispositions de l'article 26 de la Convention, qui prévalent sur la loi française interne, la société ne pouvait être soumise à la taxe litigieuse à laquelle échappent les sociétés de droit français se trouvant dans la même situation."*
[225] H. LAZARSKI, "3% tax on real property", *European Taxation* 1989, 287.

the criteria for the application of the regime *"must take into account not only their status as non-residents of France, but also necessarily their ties to a State other than France"*?)

Analysing the different arguments might clarify matters a little. The taxpayer argues that limiting the application of the tax to companies having their 'seat' ('siège') outside France amounts to a form of nationality discrimination. The tax administration responds by submitting two different arguments. First of all, the criteria used for defining the scope of applicability of the tax are based on notions independent of nationality. Secondly, companies who have their registered office ('siège social') in Switzerland and who are subject to the tax are not in the same circumstances as real estate companies[226] having their seat ('siège') in France, who are not subject to this tax. Thus, the tax administration advances two separate arguments, the first of which denies the existence of nationality discrimination by stating that the regime does not differentiate on the basis of nationality. This is a valid point: the criterion used by the regime is the 'seat' of the company, which, as stated above, refers to the place of effective management. Since the nationality of companies under tax treaties is defined in France by reference to the registered office[227], the place of effective management is indeed a notion which is independent of nationality.

The second argument pertains to the 'same circumstances' test. The tax administration submits that a company having its registered office in Switzerland (which is subject to the tax) is not in the same circumstances as a real estate company having its seat in France (which is not subject to the tax). No further argument is advanced as to why the circumstances differ. Most likely, the tax authorities refer to their traditional position that, in principle, a foreign company cannot be in the same circumstances as a French company: a French company has its registered office in France, while a foreign company does not. According to the tax authorities, such a foreign company could only be in the same circumstances as a French company if, although being registered in another country, it has its place of management in France[228]. Consequently, a national of a third State is not in the same circumstances as a national of France, unless the third State national is also a resident of France[229].

The Supreme Court responds to these arguments by referring to the nationality definition of the applicable tax treaty, read together with the domestic provision stating that companies having their registered office in France were subject to French law. The Court dismisses the first argument of the tax administration (the denial of the existence of nationality discrimination) by stating that the criteria for the application of the tax to companies having their seat outside France *"must take into account not only their status as non-residents of France, but also necessarily their ties to a State other than France"*[230].

[226] *"Sociétés à prépondérance immobilière ayant leur siège en France"*.
[227] Art. 26(2) of the 1966 French/Swiss treaty defines a national of a contracting State as *"any legal person, partnership or association deriving its status as such from the laws in force in that Contracting State"*. Art. 2 of the 1966 French Corporate Law states that companies whose registered office is located in France, are subject to French law.
[228] H. LAZARSKI, "3% tax on real property", *European Taxation* 1989, 286.
[229] As noted above, the applicable tax treaty was modelled after the 1963 OECD MC, which did not include the phrase *'in particular with respect to residence'* (see supra).
[230] *"qu'il résulte de la combinaison de ces textes que le critère tiré par l'article 990 D du Code général des impôts, pour délimiter son champ d'application, de la localisation hors de France du siège des sociétés concernées se réfère non seulement à leur qualité de nonrésident français mais aussi nécessairement à leur rattachement à un Etat autre que la France"*.

However, the gist of this reasoning is not entirely clear. Perhaps the Supreme Court implies that, on the one hand, the criterion used by the disputed regime (the 'seat' of the company) indeed refers to residence, but that, on the other hand, the combination of the nationality definition of the treaty and the domestic provision necessarily means that nationality (*"their ties to a State other than France"*) is brought into the equation as well. The combination of the treaty nationality definition (*"The term 'nationals' means: […] all legal persons, partnerships and associations deriving their status as such from the law in force in a Contracting State"*, in the French version this reads: *"toutes les personnes morales constituée conformément à la législation en vigueur dans cet Etat contractant"*) and the domestic provision (stating that companies whose registered office is located in France are subject to French law) clarifies that companies having their registered office in France are French nationals for purposes of the tax treaty. It is unclear how the Supreme Court derives from this premise the conclusion that the criteria for the application of the disputed regime must take into account *"not only their status as non-residents of France, but also necessarily their ties to a State other than France"*. The only conclusion to be drawn from the combination of the treaty nationality definition and the domestic provision is that companies having their registered office in France are French nationals for purposes of the tax treaty. This, however, has no bearing on the interpretation of the criteria of the disputed regime. The meaning of the term 'French nationals' only comes into play when constructing the hypothetical taxpayer with which to compare the complaining taxpayer (the object of comparison): the Swiss company which feels it is being discriminated against should be compared to a French company in the same circumstances. In this comparison, a 'French company' is a company having its registered office in France. If the Swiss company were to be treated more burdensome than its French counterpart, nationality discrimination would occur.

The Supreme Court seems to perceive a necessary link between the 'seat' of a company and its nationality, but this link would only exist if 'seat' as it is used in the domestic regime under scrutiny were to be interpreted as 'registered office'. As indicated above, however, the term 'seat' as it is used in the regime introducing the 3% tax means 'place of effective management'. So this interpretation would disregard the fact that the Tax Code uses 'siège', without the adjective 'social'. Thus it is hard to see how the conclusion that the 3% tax necessarily refers to nationality can be upheld. Furthermore, the Supreme Court seems to accept the basic distinction between residence and nationality of companies, as it confirms that the criteria for the application of the 3% tax to companies having their seat outside France *"must take into account* ***not only their status as non-residents*** *of France, but also necessarily their ties to a State other than France"*. Despite acknowledging the existence of this distinction, the Supreme Court perceives a necessary link between both: application of the 'seat'-criterion necessarily implies a reference to nationality (*"their ties to a State other than France"*).

The Supreme Court rejects the second argument of the administration (the incomparability) by considering that if a Swiss company is a national of Switzerland and owns real property in France, it is in the same position as a French company owning real property in France. According to the Supreme Court, the location of a company's 'seat' does not influence the comparison to be made under the non-discrimination provision. The Supreme Court thus dismisses the importance of residence in the comparison to be made under the non-discrimination provision.

At first sight, it seems that the Supreme Court's decision is diametrically opposed to the decisions mentioned above, but the specific circumstances of the French case must be stressed. Under the French tax laws in force at the time of the dispute, the taxation of a non-resident company was identical to the taxation of a resident company (apart from the 3% tax on real property), since residence was not a criterion used in domestic tax law[231]. In French corporate income tax, the concept of residence was not referred to. The scope of tax obligations was in principle the same for 'resident' and 'non-resident' companies[232]. Instead of residence, French domestic tax law used territoriality as the cornerstone in corporate income tax. As a result, the Swiss company was indeed in the same circumstances as a French national company, apart from nationality, since the difference in residence was not a relevant characteristic. Thus, the application of the 3% tax to Swiss companies while French companies were exempt, amounted to a form of discrimination on the grounds of nationality.

b. Later evolution

In 1989, the French legislator reacted to the Supreme Court's decision by amending the relevant articles in the French tax code[233]. As indicated above, the tax previously applied to companies whose seats were situated outside France. The amended version of the tax code states that the tax applies to companies whose effective seat of management is located outside France, regardless of their nationality. It has been argued that this amendment does not resolve the discrimination issue, as the effective seat of management can determine nationality as well[234]. As indicated above, the statutory seat of a company can be relied on by third parties (e.g. the tax administration) when determining whether the company is subject to French law, but this statutory seat cannot be invoked by the company if the 'real' seat is located elsewhere. Thus, the tax administration would be able to rely on the fact that a company's statutory seat is in France, despite its effective management being exercised abroad. On the other hand, a company cannot refer to its statutory seat being located abroad when its effective management is exercised in France. In such a case, the tax administration can still consider the company to be a French company[235]. As a result, the nationality of the company will in that case be determined by the place of effective management.

---

[231] See also C-270/83, *Avoir Fiscal*, 28 January 1986, in which this feature caused the ECJ to decide that discrimination occurred by not granting the French tax credit on divididends to the French PE of an insurance companies whose head office was in another Member State; see infra Part III, 2.E.I.A.a.1.a. Interestingly, France argued in that case that there were objective differences between residents and non-residents. In particular, France argued that discrimination on grounds of residence is an accepted aspect of tax jurisdiction (C-270/83, *Avoir Fiscal*, § 17: *"the difference in question is based on the distinction between ' residents' and 'non-residents', which is to be found in all legal systems and is internationally accepted. It is an essential distinction in tax law"*). The ECJ rejected this argument.

[232] See for instance Art. 209 General Tax Code defines the taxable base in the corporate income tax by referring to the profits realized by enterprises operated in France (*"des bénéfices réalisés dans les entreprises exploitées en France"*), without making a distinction between resident and non-resident entities. Similarly, Art. 206 General Tax Code defines the scope of applicability of the corporate income tax by referring to any "legal entity carrying out operations or transactions for profit." In case law, it has been confirmed that residence is of no importance in this regard; cf. H. LEHERISSEL, "France. The tax residence of companies", *European Taxation* 1999, 157.

[233] Art. 105 Law 89-935 of 29 December 1989, *Official Gazette* 30 December 1989, 16393.

[234] H. LAZARSKI, "3% tax on real property – latest developments", *European Taxation* 1990, 77.

[235] At first sight, this would seem to be the only relevant case in which reference will be made to the effective seat of management by the tax administration. However, as indicated above (see footnote 217), the 3% tax will not be applicable when the company has its seat in a State with which France has concluded a tax treaty containing an administrative assistance clause for the prevention of tax fraud and tax evasion. Thus, triangular situations are also possible, in which the company contests the applicability of the 3% tax by referring to its statutory seat being located in a State with which France has concluded a 'good' treaty, whereas the tax administration can rely on the effective management of the company being located in a third State, with which France has concluded no such treaty.

It is not entirely clear how this situation could create issues of nationality discrimination. Take for instance company A having its place of effective management in France and its statutory seat in State X. Such a company can be considered to be a French national. According to the amended tax code, the 3% tax will not be applicable, as the effective place of management is located in France. Company B on the other hand has its statutory seat in France, and its place of effective management in State X. As the tax administration can rely on the location of the statutory seat, the company can be considered to be a French national. However, the place of effective management is located abroad, which means that the 3% tax is applicable. As the 3% tax may also apply to French nationals, no nationality discrimination seems to occur. On the other hand, it may be argued that the location of the statutory seat is a relevant characteristic that must be taken into account when making the comparison. Thus, when comparing hypothetical company A referred to above (French national, not subject to the 3% tax) to company C in the same circumstances with respect to the location of the statutory seat, the results are different. Company C having its effective management and its statutory seat in State X is a State X national. As company C's place of effective management is located in State X, the 3% tax is applicable. Company A, on the other hand, is not subject to the 3%, although the circumstances are the same (the statutory seat is in State X as well; the only difference is the French nationality and the location of the place of effective management).

In 1990, the Supreme Court was asked whether the amended version of the legislation solved the discrimination issue[236]. A company having its seat in Switzerland was subject to the 3% tax and invoked the nationality non-discrimination provision of the French/Swiss tax treaty. The tax administration referred to the amendments brought about in 1989, pursuant to which the tax only applied to companies having their place of effective management abroad, regardless of their nationality.

The Supreme Court ruled in favour of the taxpayer. The Court indicated, first of all, that the nationality of a company under the tax treaty results from the location of its real seat, defined as the place of effective management and presumed to be the statutory seat[237]. The administration's first argument, that the applicability of the 3% tax depended on criteria independent of nationality, was thus dismissed by the Court which stated that the criterion used by the tax code could not be distinguished from nationality. The administration's second argument, that the Swiss company was not in the same circumstances as a French company, was dismissed in the same manner as in the earlier decision: if a Swiss company is a national of Switzerland and owns real property in France, it is in the same position as a French company owning real property in France. The location of the companies' 'seat' (i.e. its nationality) does not influence their comparability under the non-discrimination provision[238].

So in the *Roval* decision the Supreme Court held that, as far as companies are concerned, the distinction between nationality and residence is artificial insofar as the nationality of a

---

[236] Cour de Cassation 21 December 1990, No. 88-15744, *Roval*, *D.F.* 1991, No. 12, Com. 614.

[237] *"le rattachement à un Etat, auquel se réfère l'article 26 de la Convention de 1966 pour interdire la discrimination n'est autre que la nationalité, laquelle, pour une société, résulte, en principe, de la localisation de son siège réel, défini comme le siège de la direction effective et présumé par le siège statutaire"*.

[238] *"Attendu, d'abord, que le critère retenu par l'article 990 D du Code général des impôts, pour délimiter son champ d'application, fondé sur la situation hors de France du siège des sociétés ne se distingue pas de la nationalité telle que définie par l'article 26 de la Convention franco-suisse du 9 septembre 1966; Attendu, ensuite, que des sociétés françaises et suisses possédant des immeubles en France se trouvent dans la même situation au sens de l'article 26 de la Convention franco-suisse, la localisation de leurs sièges en France pour les unes et en Suisse pour les autres, donc leurs nationalités différentes, étant sans influence"*.

company depends on the location of its place of effective management. This position is much clearer than the Court's position in *Anglo-Swiss Land and Building Company*. In *Anglo-Swiss*, the Court seemed to accept the difference between residence and nationality as criteria for the applicability of tax regimes, while at the same time holding that the use of residence in defining the scope of applicability necessarily entailed an implicit reference to nationality. By contrast, in *Roval*, the Court indicated that nationality and residence coincide as far as companies are concerned. Distinguishing between both criteria would thus be artificial. While in general the concepts of residence and nationality do not coincide entirely with respect to companies (cf. supra), it must be repeated that the circumstances of the case at issue were very specific. As no tax consequences were attached to the residence of the companies in question, the only difference between them was indeed their nationality (i.e. the different location of their registered offices).

Both cases can be seen as examples of the repeated rejection by French courts[239] of the French tax administration's traditional position that, with respect to legal persons, residence and nationality are to be distinguished, and consequently, that differentiations on the basis of residence cannot be contested by invoking a nationality non-discrimination provision[240]. Both cases reject this position; the difference being that the *Roval* case is a much clearer rejection of the tax administration's position than the *Anglo-Swiss* case. In *Anglo-Swiss*, the Court seems to accept the basic distinction at first, but subsequently concludes that application of the 'seat'-criterion necessarily implies application of a nationality distinction. In *Roval* on the other hand, the Court simply states that nationality is defined by the real seat of the company, which is its place of effective management and which can be presumed to be the statutory seat. The distinction between residence and nationality is therefore irrelevant in the context of legal persons.

As a result of these decisions, the 3% tax regime was amended once again in 1992[241]. In the same year, France recorded the following reservation on Art. 24(1) OECD MC: *"FRANCE wishes to reserve the possibility of applying the provisions of paragraph 1 only to individuals, in view of the French case law and of the fact that paragraphs 3, 4 and 5 already provide companies with wide protection against discrimination."* Since the insertion of this observation, it has been France's treaty policy to propose to its tax treaty partners to add a sentence to the nationality non-discrimination provision stating that a person who is a resident of a contracting State is not in the same situation as a person who is not a resident of the contracting State, regardless of the definition of the notion of nationality[242]. It should be noted that the *Roval*-decision also resulted in the 1992 change to the OECD MC, which added the

[239] See also Conseil d'Etat 7 October 1988, No. 82784; Conseil d'Etat 17 January 1996, No. 120646: *"qu'il résulte de [l'article 26 de la convention fiscale franco-suisse] que, s'agissant des personnes morales constituées conformément à la législation suisse, la localisation hors de France de leur siège de direction effective ne se distingue pas de leur nationalité; que les sociétés françaises et les sociétés suisses qui possèdent les unes et les autres des immeubles en France se trouvant dans la même situation, au sens de l'article 26 de la convention franco-suisse, celui-ci fait obstacle à ce que les secondes soient soumises à la taxe de 3 % instituée par l'article 990 D, à laquelle échappent les premières"*.

[240] See e.g. Conseil d'Etat Plén. 19 December 1975, No. 84774.

[241] Cf. 990E of the General Tax Code, as amended by Art. 29 Loi de Finances pour 1993, 30 December 1992, no. 92-1376: *"La taxe prévue à l'article 990 D n'est pas applicable […] aux personnes morales qui ont leur siège de direction effective en France et aux autres personnes morales qui, en vertu d'un traité, ne doivent pas être soumises à une imposition plus lourde […]"* (*"The tax laid down in Article 990 D is not applicable […] to legal persons having their place of effective management in France or to other legal persons who, by virtue of a treaty, must not be subject to a heavier tax burden"*; my translation, NB).

[242] B. BOHNERT, "National Report. France", in *Non-discrimination at the crossroads of international taxation*, Amersfoort, Sdu Fiscale & Financiële Uitgevers, 2008, 276.

words ‘in particular with respect to residence’ in Art. 24(1)[243]. Furthermore, the ECJ has decided in 2007 that the 3% tax is incompatible with the free movement of capital[244].

e. Biso[245]

a. The Court’s decision

Mr and Mrs Biso resided in Monaco and owned immovable property in France. Mr Biso was an Italian national, while Mrs Biso was a British national. Under French domestic tax law, non-residents who owned immovable property in France were subject to income tax on three times the rental value of this property. The tax treaty between France and Monaco provided for a special tax regime for French nationals who had transferred their residence to Monaco. Such French nationals were considered as French residents for tax purposes[246]. As a result, French nationals residing in Monaco were not subject to the French non-residents’ tax on immovable property situated in France[247].

Mr and Mrs Biso argued that this resulted in nationality discrimination contrary to the French/Italian[248] and French/U.K. tax treaty[249]. In response, the French tax authorities contended that Italian or British nationals residing in Monaco were not ‘in the same circumstances’ as French nationals residing in Monaco. The former were not liable to income tax in their country of residence (Monaco), while the latter were liable to tax in France as if they were French residents. Pursuant to the provisions of the treaty between France and Monaco, the latter were considered to be French residents for direct tax purposes, which meant that they were not in the same circumstances as Italian or U.K. nationals.

The Administrative Court of Appeal first noted that Mr and Mrs Biso were subject to different taxation than that to which French nationals who, like them, resided in Monaco and had immovable property in France. The latter were not subject to French tax on three times the rental value of their immovable property but only on their actual income.

---

[243] J. AVERY JONES and C. BOBBETT, “Interpretation of the non-discrimination Article of the OECD Model”, *Bulletin for international taxation* 2008, 50.

[244] C-451/05, *ELISA*, 11 October 2007. The same French regime was brought before the ECJ again in C-72/09, *Etablissements Rimbaud*, 28 October 2011 and in C-384/09, *Prunus*, 5 May 2011. In the former case, which concerned an EEA State, the ECJ considered the French regime to be justified (see Part III, 2.E.8.b). In the latter case, which concerned a non-Member country, the ECJ decided in favour of the tax authorities because the French regime fell under the grandfather clause of Art. 64(1) TFEU.

[245] Cour Administrative d’Appel de Marseille 8 February 2000, No. 98MA01683, *RJF* 2001, 3, No. 363. See also P. JUILHARD, “The non-discrimination principle under the France-Monaco treaty – Further thoughts after the Biso case”, *European Taxation* 2003, 195-202.

[246] Article 7(1) of the 1963 treaty: *“Les personnes physiques de nationalité française qui transporteront à Monaco leur domicile ou leur résidence […] seront assujetties en France à l'impôt sur le revenu des personnes physiques et à la taxe complémentaire dans les mêmes conditions que si elles avaient leur domicile ou leur résidence en France.”* There were a number of exceptions to this rule, e.g. if the French national had been continuously resident in Monaco since 1957, or if he was born in Monaco and has lived there continuously. None of those exceptions were relevant in the *Biso* case.

[247] The French legislation at issue here has given rise to a number of disputes. See, for instance, Tribunal Administratif de Nice 14 December 2004, No. 9700466. In that case, a Portuguese national resided in Monaco and was subject to the French immovable property tax in respect of an appartment in Paris. The taxpayer invoked the nationality non-discrimination clause of the French/Portuguese treaty, but the Court dismissed that claim because the treaty only applied to residents of the contracting States.

[248] Art. 25(1) of the 1989 treaty, which reads as follows: *“Nationals of a State, **whether or not they are residents of one of the States**, shall not be subjected in the other State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected”* (emphasis added).

[249] Art. 25(1) of the 1968 treaty, which is identical to Art. 24(1) of the 1963 Draft Convention.

The Court then observed that the non-discrimination clauses in the French/Italian and French/U.K. tax treaties only allowed nationals of the other contracting State to be taxed differently from French nationals if that distinction was based on objective differences between them and did not result exclusively (as a result of domestic law or a bilateral treaty) from the taxpayer's nationality. In the case at hand, it was only because of the Bisos' nationality that their residence differed from that of French nationals residing in Monaco. As a result, that difference in residence could not be relied on to argue that they were incomparable to French nationals residing in Monaco[250]. The Court therefore concluded that the application of the French tax on three times the rental value of the Bisos' French immovable property gave rise to nationality discrimination.

b. Commentary

There are a number of interesting aspects to this case. First of all, the Court applies the French/Italian and French/U.K. treaties even though the taxpayers were resident of neither Italy nor the U.K. With respect to the French/Italian treaty, that is not problematic since the non-discrimination provision in that treaty applies to *"nationals of a State, **whether or not they are residents of one of the States**"*. Since that statement is not included in the French/U.K. treaty, it may seem odd that the Court nevertheless applies the treaty to the U.K. national resident of Monaco. However, it should be pointed out that, unlike the OECD MC, the scope of the French/U.K. treaty was not limited to residents of the contracting States. For that reason, there was nothing to prevent the Court from applying the non-discrimination clause even though the taxpayer was not a resident of France or the U.K. The *Biso* case was subsequently referred to the Conseil d'Etat, which confirmed this interpretation of the French/U.K. treaty[251].

A second aspect to be addressed is that the Court correctly holds that elements inherently linked with nationality should be disregarded. In the case at hand, the residence (or rather, deemed residence) of French nationals residing in Monaco was determined by their French nationality. But the interesting issue here is that the causal link between nationality and

[250] The original text of the decision reads: *"si les clauses de non-discrimination contenues dans les conventions franco-italienne et franco-britannique précitées ne s'opposent pas, en principe, ce qu'un non-résident de l'un des Etats signataires soit imposé différemment, autrement, ou plus lourdement qu'un résident de cet Etat, c'est à la condition, toutefois, que cette distinction repose sur des différences objectives de situation et ne résulte pas exclusivement, sous l'effet de règles de droit interne ou de conventions internationales, de la nationalité des intéressés; qu'en l'espèce, ce n'est qu'en raison de leur nationalité que le domicile fiscal de M. et Mme BISO diffère de celui de nationaux français résidant à Monaco et disposant d'une ou plusieurs habitations en France; que, dans ces conditions, la différence de situation qu'invoque le ministre, et dans laquelle se trouvent M. et Mme BISO au regard des règles relatives au domicile fiscal, ne saurait, sans que soient méconnus les articles 25 des conventions franco-italienne et franco-britanniques précitées, justifier qu'ils soient soumis une imposition autre, différente, ou plus lourde que celle laquelle sont assujettis les ressortissants français qui, comme eux, résident à Monaco et disposent d'une ou de plusieurs habitations en France"*.

[251] Conseil d'Etat 11 June 2003, No. 221199, *RJF* 2003, 8-9, No. 1018. See also the decisions of the Conseil d'Etat in *Campbell* (3 March 1993) and *Benmiloud* (30 December 1996), referred to earlier. It should be noted that the Conseil d'Etat reached a different conclusion than the Administrative Court on the applicability of the **French/Italian** treaty in *Biso*. As noted above, the Administrative Court of Appeal applied the 1989 treaty between France and Italy, according to which the non-discrimination clause applied to nationals of both contracting States, irrespective of their residence. However, that treaty did not apply to the tax years at issue (1988 to 1990). For that reason, the Conseil d'Etat annulled the Administrative Court of Appeal's decision on this point and decided this aspect on the basis of the 1958 treaty between France and Italy. Since that treaty only applied to residents of the contracting States and the scope of the nationality clause was not extended to include non-residents, the Conseil d'Etat held that Mr Biso could not invoke the French/Italian treaty.

deemed residence was provided for in a bilateral treaty rather than domestic law. More specifically, it was not French law that deemed French nationals residing in Monaco to be French residents, but the French/Monegasque tax treaty. The Court paid little attention to this nuance and simply held that the characteristic invoked to prove the incomparability of the situations should not result exclusively from the nationality of the taxpayers concerned, whether that link was provided for in domestic law or under a treaty[252].

When the case was subsequently brought before the Conseil d'Etat, this aspect was confirmed as well. The Conseil d'Etat held that the existence of nationality discrimination had to be considered by taking into account not only the tax provisions of domestic law but also the tax rules provided for in bilateral treaties. According to the Conseil d'Etat, Mrs Biso was comparable to a French national residing in Monaco. The difference between them, namely the fact that the latter was considered to be a French resident under the French/Monegasque tax treaty, was solely the result of their difference in nationality. As a result, the application of the French tax constituted discrimination in the case at hand[253].

As discussed in Part I, B.II, characteristics that are inherently linked with the comparative attribute should be disregarded. The Administrative Court of Appeal (confirmed by the Conseil d'Etat) decides that that should also be the case where the link between the comparative attribute (here, nationality) and the characteristic in question (here, deemed residence) is provided for in a tax treaty. Is that conclusion compatible with the relative effect of tax treaties? This is a difficult issue and unfortunately, neither of the decisions discussed here gives reasons supporting its conclusion. In my opinion, there are two issues that should be distinguished. First, characteristics that are inextricably linked with nationality cannot render nationals and non-nationals incomparable. Secondly, the non-discrimination provision in a tax treaty does not grant entitlement to benefits provided for in another tax treaty. The problem with the *Biso* case is that those two issues happened to coincide. That is to say, the deemed residence of French nationals (which was inextricably linked with their nationality) was relied on to argue that the situations were incomparable, but at the same time, the taxpayer was claiming entitlement to that deemed residence (or, rather, the benefits connected to that deemed residence) by relying on a tax treaty non-discrimination provision.

In order to avoid confusion, it is necessary to analyse both issues separately. First of all, characteristics that are inextricably linked to the comparative attribute should be disregarded in the comparability-analysis, even where that link is provided for by a tax treaty. Doing so would in no way affect the relative effect or the reciprocity of the tax treaty in question. No new obligations are imposed on either contracting State and the balance of the treaty remains intact. Secondly, the non-discrimination provision of the French/Italian or French/U.K. treaty

---

[252] See the quote reproduced above: *"c'est à la condition, toutefois, que cette distinction repose sur des différences objectives de situation et ne résulte pas exclusivement, **sous l'effet de règles de droit interne ou de conventions internationales**, de la nationalité des intéressés"* (emphasis added).

[253] The original text of the Conseil d'Etat's decision reads as follows: *"l'existence éventuelle d'une violation de cette clause de non-discrimination s'apprécie en prenant en compte non seulement les dispositions fiscales de droit interne mais également les règles fiscales qui pourraient découler d'autres conventions fiscales; que Mme X, résidente de Monaco depuis 1982, était dans la même situation qu'un ressortissant français résidant à Monaco depuis la même année et disposant également d'une habitation en France; que l'application combinée de l'article 164 C du code général des impôts et du paragraphe 1 de l'article 7 de la convention franco-monégasque a conduit l'administration fiscale à soumettre Mme X à l'imposition d'un revenu forfaitaire égal à trois fois la valeur locative réelle des habitations dont elle disposait en France, alors qu'un ressortissant français résidant à Monaco n'aurait pas été soumis à cette imposition; que **cette différence d'imposition ne résulte que d'une différence de nationalité**; que Mme X est donc fondée à soutenir que c'est en violation de l'article 25 de la convention franco-britannique qu'elle a été assujettie à l'impôt […]"* (emphasis added).

cannot be invoked in order to claim benefits provided for in the treaty between France and Monaco. Even though the situations are comparable (that is to say, even though nationals and non-nationals are not rendered incomparable by the deemed residence rule), benefits provided for in another tax treaty simply go beyond the scope of application of the non-discrimination rule. Otherwise, Art. 24 would be transformed into an MFN-clause and, as discussed earlier, that would be incorrect.

> To illustrate these issues, consider the following examples. (1) First, the domestic law of State A provides that all nationals carry a State A passport while non-nationals never carry such a passport. Furthermore, the domestic law of State A provides that all persons carrying a State A passport pay income tax in State A at a rate of 15%, while all other persons pay income tax at a rate of 30%. Can a State B national rely on Art. 24(1) of the State A/State B treaty to claim entitlement to the 15% rate? Clearly, State A cannot rely on the fact that State A nationals carry a passport in order to argue that State B nationals are incomparable to State A nationals, since that characteristic is inextricably linked to nationality[254]. As a result, State B nationals should also be entitled to the lower tax rate.
>
> (2) Secondly, the domestic law of State A provides that all nationals carry a State A passport while non-nationals never carry such a passport. Furthermore, the tax treaty between State A and State C provides that taxpayers who carry a State A passport are subject in State A to withholding tax on dividends capped at a rate of 15%, while other taxpayers are subject to withholding tax on dividends capped at a rate of 30%. Can a State B national rely on Art. 24(1) of the State A/State B treaty to claim entitlement to the 15% rate? Clearly, State A cannot rely on the fact that State A nationals carry a passport in order to argue that State B nationals are incomparable to State A nationals, since that characteristic is inextricably linked to nationality[255]. However, extending the benefit of the reduced withholding rate to State B nationals would upset the balance of the A/C treaty, since that benefit forms part of the reciprocal rights and obligations agreed upon by State A and C and constituting the legal fabric of the A/C treaty. As a result, that benefit goes beyond the scope of the non-discrimination provision of the A/B treaty.
>
> (3) Thirdly, the tax treaty between State A and State C provides that all State A nationals are entitled to a tax credit for tax withheld in State C. Furthermore, the domestic law of State A provides that all taxpayers who are entitled to a tax credit for tax withheld in State C pay income tax in State A at a rate of 15%, while all other persons pay income tax at a rate of 30%. Can a State B national rely on Art. 24(1) of the State A/State B treaty to claim entitlement to the 15% rate? Clearly, State A cannot rely on the fact that State A nationals are entitled to a tax credit for tax withheld in State C in order to argue that State B nationals are incomparable to State A nationals, since that characteristic is inextricably linked to nationality[256]. The fact that the link between the credit and nationality is provided for in a tax treaty does not change this conclusion. By considering State B nationals to be comparable to State A nationals, the relative effect and reciprocity of the A/C treaty is not affected in any way. Furthermore, since the benefit in question is provided for in State A's domestic law, it is not problematic to extend it to State B nationals. As a result, State B nationals should also be entitled to the lower tax rate.
>
> (4) Finally, the tax treaty between State A and State C provides that all State A nationals are entitled to a tax credit for tax withheld in State C. Furthermore, the tax treaty between State

[254] Assuming that the characteristic of carrying a passport is relevant from the perspective of the tax benefit at issue (see Part I, B.II).
[255] Assuming that the characteristic of carrying a passport is relevant from the perspective of the tax benefit at issue (see Part I, B.II).
[256] Assuming that entitlement to the credit is relevant from the perspective of the tax benefit at issue (see Part I, B.II).

> A and State C provides that taxpayers who are entitled to a credit for tax withheld in State C are subject in State A to withholding tax on dividends capped at a rate of 15%, while other taxpayers are subject to withholding tax on dividends capped at a rate of 30%. Can a State B national rely on Art. 24(1) of the State A/State B treaty to claim entitlement to the 15% rate? Clearly, State A cannot rely on the fact that State A nationals are entitled to a tax credit for tax withheld in State C in order to argue that State B nationals are incomparable to State A nationals, since that characteristic is inextricably linked to nationality[257]. Once again, the fact that the link between the credit and nationality is provided for in a tax treaty does not change this conclusion (see supra). But extending the benefit of the reduced withholding rate to State B nationals would upset the balance of the A/C treaty, since that benefit forms part of the reciprocal rights and obligations constituting the legal fabric of the A/C treaty. As a result, that benefit goes beyond the scope of the non-discrimination provision of the A/B treaty. This is the situation at issue in *Biso*: the characteristic relied on is inextricably linked to nationality and should therefore be disregarded, even though the link is provided for in the tax treaty, but, ultimately, the taxpayer's claim should be dismissed because the benefit in question is also provided for in a tax treaty.

That being said, it should be stressed that the analysis is different where there is a conflict between a tax treaty non-discrimination clause and a provision of **the same** tax treaty. That situation will be addressed in 2.D.III.C.e.

f. Saipem

a. The Court's decision

As a final illustration of these issues, consider the recent Canadian *Saipem* case[258]. The taxpayer, Saipem U.K., was a company incorporated and resident in the U.K. that carried on business in Canada through a PE. The taxpayer's subsidiary, SEI, was also a U.K. incorporated, U.K. resident company that carried on business in Canada through a PE. In the context of a group reorganization, SEI was wound up into Saipem U.K. At the moment of the winding-up, SEI's Canadian PE was in a loss position. In its Canadian tax return filed for the tax year following the reorganization, Saipem U.K. deducted the losses incurred by SEI's Canadian PE.

Under Canadian tax law, a parent corporation could deduct its wound-up subsidiary's loss on the condition that both qualified as 'Canadian corporations'[259]. Because neither Saipem U.K., nor SEI was a Canadian corporation, the Canadian tax authorities refused the deduction. A 'Canadian corporation' was defined as follows: *"Canadian corporation at any time means a corporation that is resident in Canada at that time and was (a) incorporated in Canada, or (b) resident in Canada throughout the period that began on June 18, 1971 and that ends at that time"*[260].

So there were two ways in which a corporation could be a 'Canadian corporation'. First, a corporation was 'Canadian' if it was resident in Canada **and** had been incorporated in Canada. Secondly, a corporation was also 'Canadian' if it was not incorporated in Canada but had been a resident since at least 1971. A corporation was **resident** in Canada if its central

257 Assuming that entitlement to the credit is relevant from the perspective of the tax benefit at issue (see Part I, B.II).
258 Tax Court of Canada 14 January 2011, *Saipem UK Limited*, No. 2008-2540(IT)G.
259 Income Tax Act Part I, Division B, Subdivision h, Section 88(1.1).
260 Income Tax Act Part I, Division B, Subdivision h, Section 89.

management and control was in Canada **or** if it was incorporated in Canada after 26 April 1965[261].

The taxpayer argued that the restriction of the Canadian rules on loss deductibility to 'Canadian corporations' infringed the nationality non-discrimination clause of the Canadian/U.K. treaty[262]. According to the taxpayer, the requirements which must be met in order for an entity to qualify as a 'Canadian corporation' amounted to requiring that the corporations were nationals of Canada. The taxpayer further stressed that granting non-discriminatory treatment in the case at hand would not mean that foreign losses were imported into Canada. Rather, the appropriate comparison was between foreign entities carrying on business in Canada through a PE and Canadian entities carrying on similar activities in Canada through a subsidiary. So the losses in question were suffered in Canada, since they were connected to the PE's activities in Canada[263].

The Court dismissed the taxpayer's argument that the 'Canadian corporation' requirement actually amounted to a nationality requirement. The Court acknowledged that, in order to qualify as a Canadian corporation, an incorporation (i.e. nationality) requirement was imposed, but that requirement was **in addition to** a residence requirement (see the definition quoted above: "*a corporation that is resident in Canada at that time and was (a) incorporated in Canada*"). Moreover, under paragraph (b) of the definition, a corporation that has been a resident since 1971 also qualified as a Canadian corporation. So paragraph (b) did not impose a nationality requirement. Accordingly, if the taxpayer and its wound-up subsidiary had been Canadian corporations under paragraph (b), the deduction would have been possible irrespective of their non-Canadian nationality.

Moreover, residence was not the equivalent of nationality under Canadian law. It was not necessary for a corporation to be incorporated in Canada in order to be a resident there. Residence could also be determined by the management and control test. As a result, it was possible for a corporation that was not incorporated in Canada to be a resident (if its management and control was there), or for a corporation that was incorporated in Canada to be a non-resident (if its place of effective management was in a contracting State with which Canada has concluded a tax treaty containing an OECD MC-style tie breaker). So corporations did not qualify as 'Canadian corporations' simply because of their Canadian nationality[264].

According to the Court, the proper comparison would be between the taxpayer (a non-national, non-resident with a non-national, non-resident subsidiary) and a Canadian national non-resident that has a non-resident wound-up subsidiary. Since the non-resident Canadian national would not qualify as a Canadian corporation, it would not have access to its wound-up subsidiary's losses[265]. As a result, the Canadian rules did not give rise to nationality discrimination.

---

[261] Income Tax Act, Part XVII, Section 250.
[262] Art. 22(1) of the 1978 treaty, which is identical to Art. 24(1) of the 1963 OECD Draft Convention. The taxpayer also invoked the PE non-discrimination clause of that treaty. That aspect of the case will be discussed in 2.D.III.C.a.4.
[263] See Tax Court of Canada 14 January 2011, *Saipem UK Limited*, para. 27.
[264] See Tax Court of Canada 14 January 2011, *Saipem UK Limited*, paras. 49-50.
[265] This is a typical example of the two-step reasoning that is sometimes made by courts when applying a non-discrimination rule. First, the Court dismisses the taxpayer's claim because the subject of comparison (which is not entitled to a certain benefit) and the object of comparison (which is entitled to that benefit) as suggested by the taxpayer are not comparable. Secondly, the Court constructs the proper object of comparison – i.e. a

b. Commentary

The Court's conclusion was correct, since residence was a relevant characteristic that was not inherently linked with nationality. Indeed, it was possible for non-national corporations to be resident and, conversely, for national corporations to be non-resident (see supra). As a result, a non-resident non-national could not be considered comparable to a resident national.

It is unfortunate, however, that the Court also finds support for this conclusion in the part of the 'Canadian corporation' test that imposed a nationality test **in addition to** a residence test. Accepting that a domestic rule is compatible with Art. 24(1) because it does not only depend on nationality **but also** on another factor would unnecessarily narrow the scope of the provision. In fact, that would amount to interpreting Art. 24(1) as only prohibiting discrimination **on the sole basis of** nationality[266]. It is true that, according to the Commentary, Art. 24(1) is concerned with discrimination 'on the grounds of nationality'[267], which could be interpreted as meaning that the provision only prohibits domestic rule that make a distinction 'on the (sole) basis of nationality'. However, as will be argued hereafter, such an interpretation would be overly restrictive. Instead, the statement in the Commentary that discrimination 'on the grounds of nationality' is prohibited should be read against the backdrop of the requirement in Art. 24(1) that the object of comparison must be 'in the same circumstances' as the subject of comparison.

V.C. Discrimination 'on the basis of' nationality?

As noted in Part I, a non-discrimination rule can generally be interpreted in two ways. Either it is interpreted as prohibiting only discrimination on the basis of a specific criterion, or it is interpreted as guaranteeing a certain minimum treatment for a certain category. Applied to Art. 24(1): this provision can either be interpreted as prohibiting only discrimination on the basis of nationality (and, thus, allowing other types of discrimination even if they are to the disadvantage of non-nationals) or as ensuring that nationals of one contracting State are entitled to treatment that is not less favourable than the treatment accorded to (certain) nationals of the other contracting State, irrespective of the basis on which the distinction is made.

Neither the OECD MC, nor the Commentary is entirely clear on which approach is preferable. The Commentary does say that Art. 24(1) *"establishes the principle that for purposes of taxation discrimination **on the grounds of** nationality is forbidden"*, which seems to favour the first interpretation, but it immediately adds that *"the nationals of a contracting State may not be less favourably treated in the other contracting State than nationals of the latter State in the same circumstances"*, which seems to favour the second interpretation[268].

---

hypothetical taxpayer to which the subject of comparison **is** comparable – and finds that that proper object of comparison is not entitled to the benefit either, with the result that there is no discrimination. Here, the object of comparison suggested by the taxpayer was a resident national, it being understood that the taxpayer contended that residence should be disregarded for being inherently linked to nationality. In its first step, the Court dismisses that claim and finds that residence is a relevant characteristic, that is not inherently linked with nationality and therefore renders a resident national incomparable to a non-resident non-national.

[266] See also 2.F.I.C.b, for a similar issue in the context of Art. 24(5) OECD MC.

[267] Comm. OECD on Art. 24, para. 5.

[268] Comm. OECD on Art. 24, para. 5 (emphasis added).

As an example of the importance of this distinction, consider the decision of the French Conseil d'Etat of 15 December 2004[269]. A Swiss company derived capital gains from the sale of immovable property situated in France. Under French domestic law, such capital gains were subject to a 50% withholding tax if they were realized by a non-resident individual or a company without a PE in France. In contrast, French companies realizing capital gains from the sale of immovable property situated in France were subject to corporation tax at the rate of 33%. The same applied if the immovable property formed part of the business property of a PE which a foreign company had in France. The Swiss company argued that this distinction constituted discrimination contrary to the nationality non-discrimination provision of the French/Swiss tax treaty[270].

The Conseil d'Etat dismissed that argument and held that the difference in treatment introduced by the French legislation was not based on the nationality of companies (i.e. the place of their statutory seat). Instead, the distinction was based on whether the immovable property formed part of the business assets of a PE which the taxpayer has in France. As a result, the 50% withholding tax also applied when the immovable property formed part of the business assets of a PE which a French company had in another State. Because the discrimination was not **on the basis of** nationality, the Conseil d'Etat concluded that the French regime did not give rise to discrimination contrary to the tax treaty[271].

It is submitted that this interpretation of the nationality non-discrimination provision is overly restrictive[272]. Article 24(1) OECD MC does not require the distinction to be made **on the basis of** nationality. That provision only requires nationals of one State to be given treatment which is not more burdensome than the treatment accorded to nationals of the other State **in the same circumstances**. Accordingly, it is necessary to first determine the appropriate subject and object of comparison. The 'appropriate' object of comparison is a national who is in the same circumstances, i.e. a taxpayer who is identical in all relevant respects apart from nationality[273].

---

[269] Conseil d'Etat 15 December 2004, No. 257337.

[270] Art. 26(1) of the 1966 treaty, which is identical to Art. 24(1) of the 1963 Draft Convention. As in the OECD MC, legal persons are 'nationals' of a contracting State if they 'derive their status as such from the law in force' in that state.

[271] The original text of the decision reads as follows: *"il résulte des dispositions précitées de l'article 244bis du code général des impôts que sont soumises au prélèvement qu'elles instituent les personnes morales qui ne disposent pas en France d'un établissement auquel seraient rattachés les immeubles faisant l'objet de leur activité […]; par suite, la différence de traitement qu'instaurent ces dispositions n'est pas fondée, s'agissant des personnes morales, sur le lieu de leur siège social, qui détermine leur nationalité, mais sur celui de l'établissement auquel se rattache l'activité immobilière exercée, qu'il s'agisse de l'établissement en France d'une société étrangère ou de l'établissement à l'étranger d'une société française"*. The Administrative Court of Appeal of Paris reached the opposite conclusion and held in favour of the taxpayer in a similar case in 2008: *"il résulte des dispositions précitées de l'article 244bis A du code général des impôts que sont soumises au prélèvement qu'elles instituent les personnes morales dont le siège social est situé hors de France; que, par suite, la différence de traitement qu'instaurent ces dispositions est fondée, s'agissant des personnes morales, sur le lieu de leur siège social, qui détermine leur nationalité"* (Cour Administrative d'Appel de Paris 16 October 2008, No. 07PA01366, *R.D.F.* No. 15, 9 April 2009, 33).

[272] See also H. LAZARSKI, "Surprising French Supreme Administrative Court decision on the interpretation of a non-discrimination clause", *European Taxation* 2005, 352-353. See also supra, on 'disguised' discrimination: a measure that does not distinguish on the basis of the prohibited criterion but on the basis of a characteristic that is inextricably linked to that criterion is incompatible with Art. 24. However, if the nationality non-discrimination clause is interpreted restrictively as only covering distinctions made on the basis of nationality, disguised discrimination would not be covered.

[273] See Part I, B.II.

Applied to the present case, the subject of comparison, a Swiss company realizing a capital gain on immovable property situated in France, is therefore compared to a French company realizing a capital gain on immovable property situated in France. The decisive question is whether the fact that the immovable property forms part of a PE is a relevant characteristic. If it is, a Swiss company which does not have a PE in France is not comparable to a French company that sells immovable property which forms part of its French establishment. From the perspective of capital gains tax levied on immovable property situated in France, that does not seem to be a relevant characteristic.

To summarize, the statement in the Commentary that Art. 24(1) prohibits discrimination 'on the grounds of' nationality should not be read as restricting the scope of the provision to domestic rules that formally distinguish on the basis of nationality. Instead, that statement should be read against the backdrop of the requirement in Art. 24(1) that the object of comparison must be 'in the same circumstances' as the subject of comparison. As pointed out in Part I, requiring the discrimination to be 'on the basis of' a certain criterion is the same as interpreting the comparability test very strictly. That is to say, a non-discrimination rule that only prohibits discrimination 'on the basis of nationality' will only be violated if **all characteristics other than nationality** are identical among subject and object of comparison. Clearly, such an interpretation would render the non-discrimination rule entirely ineffective since any difference, however irrelevant, would mean that there is no discrimination. For that reason, the comparability-test in non-discrimination rules is inherently concerned with characteristics that are **relevant** for the issue under scrutiny. In other words, the statement in the Commentary discussed here should be interpreted as confirming that Art. 24(1) precludes discrimination where **all relevant characteristics other than nationality** are identical among subject and object of comparison.

There is an additional issue to be addressed here. In particular, would Art. 24(1) be infringed where a domestic rule distinguishes on the basis of nationality **and** on another basis? In other words, should Art. 24(1) be interpreted as only prohibiting discrimination on the **sole** basis of nationality? It is submitted that that interpretation is overly restrictive. The purpose of the nationality non-discrimination rule is to ensure that nationals of one contracting State are not excluded from benefits granted by the other contracting State to its nationals. What Art. 24(1) therefore prohibits, is that non-nationals are excluded from a certain benefit by reason of their nationality. The fact that there is also an additional reason present is not immediately relevant (unless, of course, that additional reason can be seen as a characteristic that renders the situations different). So the point is not that there are some nationals who are not entitled to the benefit either. The point is that non-nationals are automatically (i.e. by reason of their nationality) excluded from the benefit.

This line of reasoning can be applied to the *Saipem* case, discussed above. In that case, the benefits at issue were only granted to Canadian corporations. Under the Canadian rules at issue, entities qualified as Canadian corporations if they were incorporated in Canada **and** resident in Canada[274]. That means that corporations not incorporated in Canada can never

[274] For the sake of the argument, I disregard the fact that entities also qualified as Canadian corporations if they had been resident since 1971. The point of the present discussion is that the Court in *Saipem* seems to find support for its conclusion that there was no nationality discrimination in the fact that the first test for qualifying as a Canadian corporation required residence **in addition to** nationality (and, therefore, not solely nationality). For that reason, the second test for for qualifying as a Canadian corporation will be disregarded here. As pointed out above, the Court was correct in deciding that there was no nationality discrimination precisely because of this second test (that is to say, because certain non-nationals qualified as Canadian corporations).

qualify as Canadian corporations. The fact that some national corporation did not qualify either does not detract from that conclusion[275]. What Art. 24(1) tries to prevent is that benefits are granted to nationals of a contracting State without it being possible for nationals of the other contracting State to have access to those benefits. So the fact that **some** nationals of the discriminating State are not entitled to the benefit either does not detract from the conclusion that excluding all non-nationals may give rise to nationality discrimination.

> Of course, that is not the end of the analysis. In particular, it should be ascertained whether the comparability-test is met. The subject of comparison, a non-incorporated non-resident, is not entitled to the benefit at issue while the object of comparison, an incorporated resident, is so entitled. As pointed out above, the Tax Court of Canada correctly decided that these situations were not comparable because of the difference in residence. This relevant characteristic was not inherent in the comparative attribute (nationality) since it was possible for non-national corporations to be resident and, conversely, for national corporations to be non-resident.
>
> But that does not mean that there is never nationality discrimination when an additional requirement is imposed, apart from nationality. In particular, there will be discrimination if the requirement imposed in addition to nationality is irrelevant in the context of the measure at issue. Assume, for instance, that the Canadian rules in *Saipem* would have defined 'Canadian corporations' as corporations incorporated in Canada that are **also** listed on a Canadian stock exchange. Clearly, being listed on a Canadian stock exchange is irrelevant for the purposes of a measure concerning the deductibility of a wound-up subsidiary's losses. Accordingly, that characteristic does not render the situations incomparable. Secondly, there will be discrimination if a requirement is imposed in addition to nationality and that additional requirement is inextricably linked with nationality. Consider, for instance, a national rule that grants a tax benefit to national individuals who **also** hold a passport issued by that State. Since holding a passport issued by that State is a characteristic that is inextricably linked with nationality, it should be left out of the comparability-analysis, with the result that it does not render the situations incomparable.

VI. The disadvantage test: 'other or more burdensome'

VI.A. General

Art. 24(1) prohibits 'other or more burdensome' tax treatment of non-nationals. Even though this may seem obvious, it is important that the disadvantage incurred by the taxpayer is **due to** the tax rules under scrutiny. That is not the case, for instance, if a contracting State does not distinguish between nationals and foreigners, but a foreigner is nevertheless incurs a disadvantage because of a disparity between the tax systems of the contracting States involved[276].

[275] Since Canadian corporations had to be incorporated **and** resident in Canada, the options were:

1. Non-incorporated non-resident: NO
2. Non-incorporated resident: NO
3. Incorporated non-resident: NO
4. Incorporated resident: YES

[276] See e.g. Canadian Tax Appeal Board 8 February 1951, *Crawford v the Queen*, 1951 CarswellNat 40, which concerned the nationality non-discrimination clause included in para. 12 of the Protocol to the 1942 Canadian/U.S. treaty (*"The citizens of one of the Contracting States residing within the other Contracting State shall not be subjected to the payment of more burdensome taxes than the citizens of such other State"*). The taxpayer, a U.S. national resided in Canada and was therefore subject to tax on his total income in both States (in the U.S. on the basis of his nationality and in Canada on the basis of his residence). The U.S. considered certain

As a preliminary remark, it should also be pointed out that the 'treatment' itself – i.e. the tax measure under scrutiny – must not be other or more burdensome. The fact that the complaining taxpayer may benefit from a special regime in his home State or in the source State which lowers his final tax burden is irrelevant. If the measure at issue is discriminatory, the discrimination is not removed by proving that the complaining taxpayer is actually better off than nationals of the discriminating State because of a beneficial regime in the home State or the source State.

> An interesting case was decided by the Supreme Administrative Court of Sweden in 1986[277]. A Danish national was married to an official of the British embassy in Sweden. Under Swedish law at the time, officials of foreign embassies were treated as non-resident taxpayers. The same was true for their spouses if the spouse was not a national of Sweden. Even though they were in fact residing in Sweden, both spouses were thus only taxed on their Swedish income. Consequently, they generally enjoyed a more favourable tax treatment than Swedish nationals who, in the same circumstances, would be taxable as residents on their worldwide income. However, in the particular case, the treatment as a non-resident was to the disadvantage of the Danish taxpayer: a personal exemption was denied, as it was only available for resident taxpayers.
>
> The Court decided that this amounted to a violation of the non-discrimination provision of the treaty: if the taxpayer had been a Swedish national, she would have been taxed as a resident taxpayer and, consequently, would have been granted the exemption. One may infer from this case that the question as to whether treatment is more burdensome should be determined *in concreto*, i.e. without taking into account the fact that foreigners are *generally* favoured by the provision at issue. The issue of counterbalancing advantages, i.e. the question whether a discrimination may be removed by an offsetting advantage, has received considerable attention in the ECJ's case law (see Part III, 2.E.I.B), but not so much in the context of Art. 24 OECD MC.

In the context of Art. 24(1), 'other' and 'more burdensome' are alternatives: in order to be discriminatory, it is enough that the taxation of the non-national occurs on a legal basis different from that used for the taxation of nationals. This taxation needs not be more burdensome as well. It might be argued, therefore, that the addition of 'or more burdensome' is superfluous, as any treatment which is 'more burdensome', is by definition also 'other' treatment. However, it must be borne in mind that the nationality non-discrimination provision of the OECD MC originates from age-old treaties in non-tax matters (see supra). The expression 'other or more burdensome' taxation, or similar expressions to that effect,

---

receipts of that taxpayer to constitute taxable income. However, those receipts were not considered to constitute taxable income in Canada. As a result, the credit for foreign tax granted in Canada was less than the actual amount of tax paid in the U.S. The Court correctly held that this disadvantage was not due to nationality discrimination but due to the fact that the U.S. considered the receipts in question to constitute taxable income while Canada did not (*"It is true […] that, inasmuch as he is a citizen of the United States and, under the U.S. legislation, is required to pay income taxes on his total income to the government of that country; and, because he is a resident of Canada, he is subjected to income tax here on his total income from all sources (subject to a credit in respect of foreign taxes paid on income derived from foreign sources), this particular taxpayer is paying more in income taxes to the combined governments of the two countries than would be the case if he had Canadian nationality and resided here. But the increased tax which has to be borne by the appellant arises by reason of the fact that, under the United States legislation, certain receipts are deemed to be income and are subjected to tax there, which are not deemed to be income under the Canadian legislation, and accordingly are not subjected to tax here"*).

[277] *RÅ* 1986, note 785, discussed in K. STÅHL, "The application of the treaty non-discrimination principle in Sweden", *Intertax* 2000, 195.

have been used for centuries in commercial, diplomatic and other treaties[278]. In the past, foreigners were often subject to other taxes than nationals of a State. In order to avoid such different treatment, treaties would contain a provision prohibiting 'other' taxation than the taxation which applied to nationals of the State[279]. However, this prohibition would not be sufficient, as it was still possible to subject foreigners to the same tax as nationals, but to levy this tax in a more burdensome manner (for instance, by applying higher rates, by introducing formalities which are more burdensome, etc.). Therefore, the prohibition of 'more burdensome' taxation was subsequently included in those treaties in order to eliminate such treatment.

In that historical context, the addition of 'more burdensome' is therefore not superfluous, as both phrases concern different situations[280]. Whereas 'other' refers to the situation where a foreigner is subject to a different tax entirely, 'more burdensome' refers to the situation where a foreigner is subject to the same tax as a national, but where this tax is levied in a more burdensome manner[281].

As pointed out earlier, the draft non-discrimination provision proposed by the OEEC Fiscal Committee was inspired by provisions included in the tax treaties concluded by the U.K. in the 1940's and early 50's. In line with a number of those treaties[282], the first report of Working Party no. 4 referred to *"other, higher or more burdensome"*. Ultimately, however, the Working Party opted for *"other or more burdensome"*, the same expression that is currently used in the OECD MC[283]. The Working Party explained that expression to mean *"that tax may not be in another form (no different tax, no different mode of computing the*

---

[278] For instance, Art. 3 of the 1794 'Jay Treaty' between the United States and Great Britain, referred to above: *"All Goods and Merchandize whose Importation into His Majesty's said Territories in America, shall not be entirely prohibited, may freely, for the purposes of Commerce, be carried into the same in the manner aforesaid, by the Citizens of the United States, and such Goods and Merchandize* ***shall be subject to no higher or other Duties than would be payable by His Majesty's Subjects*** *on the Importation of the same from Europe into the said Territories. And in like manner, all Goods and Merchandize whose Importation into the United States shall not be wholly prohibited, may freely, for the purposes of Commerce, be carried into the same, in the manner aforesaid, by His Majesty's Subjects, and such Goods and Merchandize* ***shall be subject to no higher or other Duties than would be payable by the Citizens of the United States*** *on the Importation of the same in American Vessels into the Atlantic Ports of the said States. […]* ***No higher or other Tolls or Rates of Ferriage than what are, or shall be payable by Natives****, shall be demanded on either side"*, H. MILLER, *Treaties and other international acts of the United States of America. Documents 1-40 (1776-1818)*, Washington, U.S. Government Printing Office, 1931, 247-248 (emphasis added). Another example is Art. X of the 1654 Treaty between Great Britain and Portugal which provides that *"the goods or merchandize […] shall be freely transported into any other ports or places whatsoever of His said Majesty,* ***without paying any other or farther custom, duty or sum of money, besides what the Portugese merchants should pay****, if the goods and merchandize belonged to them"*, L. HERTSLET, *Hertslet's Commercial Treaties: A Complete Collection of the Treaties and Conventions, and Reciprocal Regulations, at Present Subsisting between Great Britain and Foreign Powers*, London, Richard Clay & Sons Ltd., Vol. II, 1840, 13 (emphasis added).

[279] See, for instance, the 1535 Treaty of Peace and Alliance between France and the Ottoman Empire, referred to earlier, which only prohibited 'other taxation'.

[280] For an example, see infra, the *Woodend Rubber* case.

[281] See also the 2006 U.S. Model Convention, which only prohibits 'more burdensome' taxation in Art. 24(1). The relevant Technical Explanation points out that the U.S. Model, unlike the OECD MC, omits the reference to taxation that is 'other than' that imposed on U.S. persons *"because the only relevant question under this provision should be whether the requirement imposed on a national of the other Contracting State is more burdensome. A requirement may be different from the requirements imposed on U.S. nationals without being more burdensome."*

[282] E.g. Art. XVIII(1) of the 1948 Dutch/U.K. treaty; Art. XVI(1) of the 1950 Myanmar/U.K. treaty; Art. XVIII(1) of the 1950 Sri Lanka (Ceylon)/U.K. treaty.

[283] As pointed out in 1.C, inspiration for that expression was most likely found in Art. XXI(1) of the 1945 U.K./U.S. treaty.

taxable amount, no different rate, etc.) and that the formalities connected with the taxation (returns, payment, prescribed times, etc.) may not be more onerous"[284]. Consequently, 'other' (or 'in another form') and 'more burdensome' (or 'more onerous') apparently refer to different obligations: the former to the taxation itself, and the latter to the connected formalities.

The Commentary to Art. 24 OECD MC seems to support this interpretation as well, where it states that 'other or more burdensome' means *"that when a tax is imposed on nationals and foreigners in the same circumstances, it must be in the same form as regards both the basis of charge and the method of assessment, its rate must be the same and, finally, the formalities connected with the taxation (returns, payment, prescribed times, etc.) must not be more onerous for foreigners than for nationals"*[285]. The basis of charge, the method of assessment and the rate must be the same for nationals and foreigners (prohibition of other treatment), whereas the formalities connected with the taxation must not be more onerous for foreigners (prohibition of more burdensome treatment). Thus, the Commentary indicates that 'other' and 'more burdensome' concern two separate situations, which must not be confused.

There is a subtle difference with the French text of this Commentary, which reads: *"les mots 'ne sont soumis à aucune imposition ou obligation y relative, qui est autre ou plus lourde' signifient que l'impôt appliqué aux nationaux et aux étrangers se trouvant dans une situation identique doit revêtir la même forme, que ses modalités d'assiette et de liquidation doivent être semblables, son taux égal et, enfin, que les formalités relatives à l'imposition (déclaration, paiement, délais, etc.) ne peuvent être plus onéreuses pour les étrangers que pour les nationaux."*

The requirements that the rates must be the same and that the formalities connected with the taxation must not be more onerous are identical in both texts, but where the English version holds that the **tax must be in the same form as regards both the basis of charge and the method of assessment**, the French version states that the **tax must be in the same form, and the basis of charge and the method of assessment must be similar** (*"que l'impôt […] doit revêtir la même forme, que ses modalités d'assiette et de liquidation doivent être semblables"*). Whereas 'the same form' and 'la même forme' both refer to equality, the term 'semblable' seems to refer to mere similarity. One is left to wonder why the French version does not simply use the expression 'la même forme' for the tax, the basis of charge and the method of assessment, as the English version does. Despite this difference, however, it is remarkable that both the English and the French version of the Commentary use a different word with regard to the tax rate on the one hand (*the same* / *égal*), and the basis of charge and method of assessment on the other hand (*in the same form* / *semblable*). This might perhaps indicate that differences with respect to tax rates should be judged more harshly than differences with respect to the basis of charge and the method of assessment (equality is required for the former, whereas isomorphism / similarity suffices for the latter).

At first sight, the idea behind the differentiation between 'other' treatment (concerning basis of charge, the method of assessment and the rate) and 'more burdensome' treatment (concerning the formalities) seems to be that it is impossible for States to apply the **same** formalities to nationals and foreigners. Due to the additional administrative burdens when dealing with foreigners, it might be inevitable to impose different formalities. The OECD MC

[284] FC/WP4(57)3, 5.
[285] Comm. OECD on Art. 24, para. 15.

does not preclude this, as long as the resulting treatment is not **more burdensome** for foreigners.

In most cases, however, the reason why administrative difficulties are greater when dealing with foreigners, is that foreigners are often non-residents. For instance, where non-residents are concerned there are additional difficulties resulting from the distance between the taxpayer and the tax administration, difficulties as regards access to information, etc. As discussed earlier, residents and non-residents are not 'in the same circumstances' under Art. 24(1). As a result, distinguishing between them does not give rise to discrimination, since resident nationals of a State are not comparable to non-resident non-nationals. Therefore, factors relating to differences in residence cannot explain why 'formalities' are governed by a different standard than the basis of charge, the method of assessment and the rate. Thus, the mere fact that different formalities are sometimes inevitable with respect to foreigners is not sufficient in itself to explain the different wording in Art. 24(1). Perhaps, an additional reason for that difference is the possibility of reverse discrimination.

VI.B. Reverse discrimination

'Other or more burdensome' contains two separate prohibitions, one of which is an expression of the principle of equality, whereas the other expresses the non-discrimination principle. As indicated earlier, the principle of non-discrimination implies that the subject of comparison must not be treated less favourably than the object of comparison. This principle does not preclude reverse discrimination: foreigners receiving preferential tax treatment are not treated less favourably than nationals. The principle of equality, on the other hand, implies that the treatment of the subject and the object of comparison must be the same. Reverse discrimination falls foul of this principle, as any difference in treatment is prohibited. Equal treatment demands equality, no more, no less.

It follows from the wording of para. 15 of the Commentary to Art. 24 (cf. supra) that the two prohibitions both refer to a different segment of 'any taxation or any requirement which is connected therewith.' The first prohibition requires 'the taxation' of foreigners (taxable basis, assessment method and tax rate) to be the same as the taxation of nationals. This amounts to an equal treatment-requirement: the tax which applies to nationals, must also be applied to non-nationals. As soon as the tax itself differs among these groups, the prohibition has been violated. The second prohibition on the other hand, implies a non-discrimination requirement: foreigners must not be treated less favourably than nationals with regard to the 'connected requirements' (the formalities[286]). The manner in which taxes are levied on foreigners, must

[286] Strictly speaking, the text of Art. 24(1) only refers to **requirements**, not to formalities as such. Moreover, Comm. OECD on Art. 24, para. gives the following examples of 'formalities connected with the taxation': *"returns, payment, prescribed times, etc."* At first sight, this seems to suggest that the expression is limited to things which the taxpayer is required to do. However, that interpretation might be too narrow. See, for example, High Court London, Queen's Bench Division, 12 April 1991, *R. v Inland Revenue Commissioners Ex p. Commerzbank AG*, [1991] S.T.C. 271, in which a German bank had paid more tax to the U.K. tax authorities than it was due. The bank succeeded in recovering the overpayments, but not until many years later. The tax authorities refused to pay any interest on the repayment, even though such interest would have been paid to a resident taxpayer. This absence of entitlement to interest on the repayment was found to be a requirement connected with the taxation which was more burdensome. Nevertheless, it did not violate the nationality non-discrimination provision of the German/U.K. treaty, because the national measure did not discriminate on the basis of nationality but on the basis of residence (the appropriate comparison to be made under the nationality non-discrimination provision was with a U.K. incorporated, German resident company with a U.K. branch; as

not be more burdensome than the manner in which these taxes are levied on nationals. Put briefly, the taxes must be the same (equality), the way in which they are levied must not be more burdensome on foreigners (non-discrimination).

As a result, the prohibition of ‘other or more burdensome treatment’ does not imply that reverse discrimination is disallowed: insofar as the tax itself is the same, the manner in which this tax is imposed may be more favourable for foreigners. So Art. 24(1) does not prohibit granting non-nationals an advantage; only disadvantaging them is prohibited. Consequently, a State which grants preferential tax treatment to certain non-nationals in order to attract foreign investment, does not violate Art. 24(1). However, it follows from the OECD Commentary referred to above that such reverse discrimination is only possible with respect to the formalities connected with the taxation, since that is the only aspect to which ‘more burdensome’ (principle of non-discrimination) refers. By contrast, the tax rates, the method of assessment and the basis of charge must be the same (principle of equality)[287]. This implies that a State may not attract foreign investors by offering them lower tax rates: the rates must be the same among foreigners and nationals. States only have some elbow room in adjusting the formalities applicable to foreigners. It seems difficult to render a tax system more attractive to foreigners by merely allowing them, for instance, more flexible return formalities or longer time-limits. Furthermore, Art. 24(1) requires the non-nationals to be in the same circumstances, ‘in particular with respect to residence’. As a result, the fact that reverse discrimination is allowed under Art. 24(1) has nothing to do with issues relating to distance with regard to non-nationals residing abroad[288]: such non-nationals are not in the same circumstances as resident nationals.

Further support for the position that Art. 24(1) does not preclude reverse discrimination can be found in para. 14 of the OECD Commentary to Art. 24: *“Furthermore, paragraph 1 has been deliberately framed in a negative form. By providing that the nationals of a Contracting State may not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of the other Contracting State in the same circumstances are or may be subjected, this paragraph has the same mandatory force as if it enjoined the Contracting States to accord the same treatment to their respective nationals. But since the principal object of this clause is to forbid discrimination in one State against the nationals of the other, there is nothing to prevent the first State from granting to persons of foreign nationality, for special reasons of its own, or in order to comply with a special stipulation in a double taxation convention, such as, notably, the requirement that profits of permanent establishments are to be taxed on the basis of separate accounts, certain concessions or facilities which are not available to its own nationals. As it is worded, paragraph 1 would not prohibit this.”*

It is clear, therefore, that reverse discrimination is allowed under Art. 24(1) (subject to the limitations referred to above)[289]. Para. 14 of the Commentary indicates that Art. 24(1) has been ‘deliberately framed in a negative form’ to allow such reverse discrimination. This

---

such a company would not be entitled to repayment supplement either, there was no discrimination). The case was later brought before the ECJ: see infra, Part III, 2.E.I.A.a.1.b. On whether the refusal to pay interest violated Art. 24(3), see infra, 2.D.III.C.b.

[287] Assuming that ‘the same’ and ‘in the same form’ are synonymous; see supra.

[288] If a State were to take these issues into account, it might for instance introduce measures of reverse discrimination such as granting foreign taxpayers longer time limits for filing a tax return, etc.

[289] See also supra, 1.C, on the statement made in this regard by Working Party no. 4 in 1957.

assertion, however, is not entirely convincing. Not the negative wording of the provision, but rather the reference to the principle of non-discrimination renders reverse discrimination possible. By contrast, if the provision were entirely based on the principle of equality, reverse discrimination would not be possible. A reference to the principle of equality can be written in a positive form (‘must be the same’) as well as a negative form (‘must not be different’). The same is true for the principle of non-discrimination: it can be referred to in the positive (‘must at least be equally favourable’) or in the negative (‘must not be less favourable’). The Commentary thus seems to confuse the difference between the principles of equality and non-discrimination on the one hand, and the difference between the positive and negative expression of these principles on the other hand. The first of these differences determines whether reverse discrimination is possible, the second does not influence this issue. It is true that the principle of equality is often construed as a positive obligation (the obligation to do something, i.e. to treat two groups equally) whereas the principle of non-discrimination is often construed as a negative obligation (the obligation to refrain from something, i.e. from treating one group less favourably than another group). This, however, does not detract from the fact that the substance of a principle should not be equated with its usual form. The custom of writing the principle of equality in the positive, and the principle of non-discrimination in the negative, should not lead to the conclusion that a provision written in the positive refers to equality and a provision written in the negative refers to non-discrimination.

Furthermore, para. 15 of the OECD Commentary to Art. 24, which seems to limit the possibility of reverse discrimination to the formalities connected with the taxation (cf. supra), starts by stating that it is ‘subject to the foregoing observation’, i.e. that it is subject to para. 14, which stresses that reverse discrimination is allowed. It may be argued that, by doing this, para. 14 tries to make clear that the possibility of reverse discrimination extends to the entire nationality non-discrimination provision. Even though the use of the words ‘the same’ and ‘in the same form’ with regard to the tax rate, the method of assessment and the basis of charge seems to imply that reverse discrimination is precluded, the statement that para. 15 is subject to para. 14 may imply the opposite: reverse discrimination is possible, also with respect to the tax rates, the method of assessment and the basis of charge.

In literature, the opposite position has been defended as well. COLIN and SINKONDO, for instance, argue that Art. 24 OECD MC goes beyond a simple prohibition of less favourable treatment of foreigners (non-discrimination), and also prohibits more favourable treatment of foreigners (equal treatment; prohibition of reverse discrimination)[290]. Those authors find support for this prohibition of equal treatment in the historical background of the OECD: this organization was created by States with a similar level of development, which meant that granting favourable treatment to foreigners would have little economic significance. Less-developed States, on the other hand, would benefit from being able to grant favourable treatment to foreigners, as these States may attract foreign investors by doing so. Para. 14 of the OECD Commentary to Art. 24, which allows States, “for special reasons of their own”, to grant favourable treatment to foreigners (see supra) was therefore included in the Commentary specifically for those countries.

This would mean that the principle underlying Art. 24(1) is the principle of equality, and that reverse discrimination is only allowed by way of exception. It is, however, difficult to deny the clear wording of Art. 24 (which, incidentally, is entitled ‘non-discrimination’ and not ‘equal treatment’) by referring to the historical context surrounding the drafting of the MC. As

[290] J. P. COLIN and M. SINKONDO, “Principe de non-discrimination et protection de la concurrence en droit international et en droit communautaire”, *Revue du Marché commun et de l’Union européenne* 1993, 47

argued above, Art. 24(1) is only partially based on the principle of equality. It cannot be held that the entire provision is based on the principle of equality, with a specific exception for less-developed countries which would be based on the principle of non-discrimination. The principles of equality and non-discrimination co-exist in Art. 24(1); neither supersedes the other, as both govern separate situations.

Finally, a third interpretation is possible, according to which equal treatment as well as non-discrimination allow reverse discrimination. The argument goes that both principles are aimed at the foreigner, and both entitle the foreigner to a certain treatment. A State which binds itself to equal treatment of foreigners only creates rights for the foreigners, not for its own nationals. As a result, equal treatment is a guarantee for the foreigner, but not for the national. A State is thus not precluded from treating foreigners more favourably than its own nationals, as no obligations towards the nationals flow from the equal treatment-provision[291]. In my opinion, this approach is incorrect, as it reduces the principle of equality to a rephrasing of the non-discrimination principle. As indicated above, there is an important difference between equality and non-discrimination on the one hand, and the positive and negative expression of these principles on the other hand. When one says that equality merely amounts to entitling foreigners to treatment which is at least as favourable as the treatment of nationals, one rephrases the negative expression of the non-discrimination principle ('foreigners must not be treated less favourably than nationals') into the positive expression thereof ('foreigners must be treated at least as favourably as nationals'). The principle of equal treatment demands two situations to be treated equally, no more, no less. The fact that the provision is aimed at protecting foreigners, does not change anything. When a State binds itself to treating two categories of taxpayers equally, it must do so.

As a result, it seems that reverse discrimination is possible under Art. 24(1), but limited to the formalities connected with the taxation. Several domestic provisions can be found which do, in fact, grant more favourable treatment to foreign taxpayers. Obvious examples are expatriate regimes which grant benefits to qualifying foreigners (e.g. managers)[292]. In case the benefits are granted to foreigners who are in the same circumstances (in particular with respect to residence[293]) as nationals who do not receive the benefits, there is reverse nationality discrimination. If the benefits which are granted to such expatriates concern fiscal measures other than mere formalities connected with the taxation, the reverse discrimination would be disallowed by Art. 24(1), as set out above.

Furthermore, certain treaties governing international organisations exempt the income of employees of such organisations. This, too, amounts to reverse discrimination, insofar as

---

[291] W. DIRKSEN, "Fiscale non-discriminatie (I), *WFR* 1974, 368

[292] For instance, the beneficial Belgian regime for foreign executives, as set out in Circular no. Ci. RH. 624/325.294 of 8 August 1983 which is only applicable to persons having a foreign nationality. This condition has been interpreted as excluding persons having the Belgian nationality, even if they have another nationality as well; cf. Brussels Court of Appeal 9 March 1993, *FJF* 93/241; F. DIERCKX, "New privileged tax treatment for foreign executives temporarily in Belgium", *European Taxation* 1983, 319. In 2001, the Belgian Constitutional Court was asked whether the Belgian regime was discriminatory *vis-à-vis* Belgian executives having an international career (*Official Gazette* 29 January 2001, 2962). However, the case was never decided by the Constitutional Court, as the taxpayer withdrew his complaint before the start of the procedure (Order no. 2250 of 21 January 2003, *Official Gazette* 24 October 2003, 51964).

[293] For instance, the Belgian regime for foreign executives is made subject to the condition that the foreign executive is still connected with his country of origin in a manner which renders him a non-resident of Belgium. The Circular enumerates several criteria which may demonstrate this (e.g. the fact that the executive's family resides in the country of origin, the fact that the taxpayer has a dwelling, bank accounts, life insurance, etc. in the country of origin).

foreign employees of an international organisations (e.g. NATO[294]) reside in a State and are exempt from income tax on their salary, whereas nationals residing in the same State are subject to income tax on their salary. It might be argued that such reverse discrimination falls foul of Art. 24(1) OECD MC, as this goes beyond granting benefits to foreigners in the field of 'connected requirements.' Of course, this would involve an additional issue, in that the benefit in question is granted by the provisions of a bilateral or multilateral treaty rather than by domestic law. The principles that govern this issue will be discussed elsewhere.

Reverse discrimination in the ECJ's direct tax case law will be discussed in Part III, 2.D.II.

VI.C. Other issues

The prohibition of 'other taxation' must not be read as obligating a Contracting State to extend benefits resulting from a tax treaty concluded with a third State to non-nationals. In other words, a State A national cannot invoke Art. 24(1) of the treaty between State A and State B in order to claim treaty benefits in State B of the treaty between State B and State C. Tax relief provided for by a Contracting State in a tax treaty is inseparably linked with corresponding concessions granted by the other State and is therefore by its very nature restricted to the two States parties to the treaty[295].

Secondly, given the wording of the MC and the Commentary, it is clear that the burden of proof of being treated in a manner which is other or more burdensome rests upon the taxpayer. It has been suggested that such an imposition of the burden of proof upon the taxpayer in itself may constitute a less favourable treatment[296]. However, this adverse treatment flows directly from the application of the tax treaty itself and is not a result of a difference in treatment by a Contracting State. Consequently, the non-discrimination provision of the treaty cannot be relied on to eliminate this 'less favourable' treatment[297].

Finally, it should be noted that, according to the Commentary, the expression 'connected requirements' refers to requirements that are connected with the taxation of the subject of comparison. In particular, the Commentary states that *"the words 'shall not be subjected to any taxation or any requirement connected therewith which is other or more burdensome' mean that **when a tax is imposed** on nationals and foreigners […] the formalities **connected with the taxation** […] must not be more onerous"*[298]. This implies that the requirements must be connected with the taxation of the subject of comparison, and not with the taxation of some other person. In other words, the 'requirements' in question do not extend to requirements imposed on the subject of comparison when those requirements concern the taxation of other persons, such as the requirement to report income or withhold taxes with respect to payments to those other persons. However, it could be argued that this interpretation unduly restricts the scope of application of Art. 24 OECD MC: nothing in the text of the provision suggests that

[294] Art. XIX of the Agreement on the Status of the North Atlantic Treaty Organization, National Representatives and International Staff, signed at 20 September 1951 in Ottawa
[295] K. VOGEL, *o.c.*, 1295. See also infra, 2.B.VII.
[296] J. O'BRIEN, "The nondiscrimination article in tax treaties", *Law and Policy in International Business* 1978, 568.
[297] See infra 2.B.VI.D.b and 2.D.II.C.e for an analysis of case law dealing with discrimination caused by application of a tax treaty.
[298] Comm. OECD on Art. 24, para. 15 (emphasis added).

formalities imposed on the subject of comparison, but relating to the taxation of another person, go beyond that scope.

VI.D. Case law

a. Woodend Rubber and Tea[299]

As argued above, Art. 24(1) uses ‘other’ to refer to the situation where a foreigner is subject to a different tax entirely, whereas ‘more burdensome’ is used to refer to the situation where a foreigner is subject to the same tax as a national, but where this tax is levied in a more burdensome manner. Attention to this distinction was drawn in the Privy Council’s decision in the *Woodend Rubber* case.

Woodend Rubber Ltd. was a U.K. company, engaged in agricultural activities in Sri Lanka (which at the time and until 1972 was called Ceylon). The operations were controlled from the U.K., where Woodend Rubber’s head office was situated. For the purpose of Ceylon income tax, the company was treated in Ceylon as a non-resident.

A 1959 Act amended the Ceylon tax system. One of the changes brought about by the 1959 Act was the introduction of additional taxation on non-resident companies, such as Woodend Rubber Ltd. The additional taxation resulted from Art. 53 C (1) of the 1959 Act, which stated:

> *The tax to which a non-resident company shall be liable:*
> *(a) shall, where there are remittances of such company in the year preceding such year of assessment, consist of a sum equal to 45 per cent, and an additional 6 per cent, of the taxable income of such company for such year of assessment and a sum which shall, if the aggregate amount of such remittances is less than one-third of such taxable income, be equal to $33^{1/3}$ per cent, of such aggregate amount, and, if such aggregate amount is not less than one-third of such taxable income, be equal to $33^{1/3}$ per cent, of one-third of such taxable income; and*
> *(b) shall, where there are no such remittances, consist of a sum equal to 45 per cent, and an additional 6 per cent., of such taxable income.*

Remittances were defined in Art. 53 C (2) as:

> *(a) sums remitted abroad out of the profits of that company,*
> *(b) such part of the proceeds of the sale abroad of products exported by that company as is retained abroad, and*
> *(c) in respect of any products exported by that company and not sold in a wholesale market; or not sold at all, such part of the profits deemed under section 38 to be derived from Ceylon as is retained abroad.*

Thus, when there were remittances of a non-resident company in the year preceding the year of assessment, an additional tax of $33^{1/3}$ % was due. Resident companies were also subject to a 45% tax rate on the taxable income, and to a $33^{1/3}$ % tax on the gross amount of dividends distributed. The $33^{1/3}$ % tax on resident companies was, however, deductible from the

[299] Privy Council, London, *Woodend Rubber and Tea Co. Ltd. v. Commissioner of Inland Revenue*, 29 April 1970, *A.C.* 1971, 321.

dividends[300]. The company argued that the additional taxation on non-resident companies amounted to a form of discrimination prohibited by the 1950 tax treaty between Ceylon and the U.K.[301], which provided in Art. XVIII:

> *1. The residents of one of the territories shall not be subjected in the other territory to any taxation or any requirement connected therewith which is other, higher or more burdensome than the taxation and connected requirements to which the residents of the latter territory are or may be subjected.*
> *[…]*
> *3. In this Article the term "taxation" means taxes of every kind and description levied on behalf of any authority whatsoever.*

The text of Art. XVIII(1) clearly deviates from Art. 24(1) the current OECD MC in several regards (the most obvious of which is that residence, instead of nationality is used as a reference point). The differences are, however, of little relevance, as the importance of the *Woodend Rubber* case lies in its interpretation of the phrase 'other or more burdensome', and this phrase is identical in both the 1950 treaty and the OECD MC (the insertion of 'higher' in the 1950 treaty between other and 'more burdensome' does not add anything to the meaning of the phrase[302]).

The case eventually came before the Supreme Court of Ceylon, which ruled in favour of the tax administration. The taxpayer appealed against that decision to the Privy Council (which acts as a court of appeal from British Courts in overseas territories).

The Council first considered whether the additional tax was 'higher or more burdensome' than the taxation to which resident companies were subject. The Ceylon Supreme Court had compared the tax actually paid by Woodend Rubber Ltd. to the tax it would have paid had it

[300] Art. 53 D of the 1959 Act.
[301] Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of Ceylon for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, 26 July 1950.
[302] The wording 'other, higher or more burdensome' is often found in older treaties (e.g. Art. XVIII(1) of the 1948 Dutch/U.K. treaty; Art. 21(1) of the 1958 Egyptian/Swedish treaty; Art. XIX(1) of the 1960 Italian/U.K. treaty; etc.). According to the IBFD Tax Treaty Database, 116 treaties (74 of which have now been terminated) contain this phrase either in the nationality discrimination provision or in the PE discrimination provision. A significant number of these treaties was concluded by either the U.K., Denmark, Norway or Switzerland. It could be argued that 'other' refers to a different tax, while 'higher' refers to the tax rate. That may have important implications. I have argued above that the obligations imposed by Art. 24 OECD MC with regard to the taxable basis, the assessment method and the tax rate are governed by the principle of equality (prohibition of 'other' taxation), whereas the obligations relating to the formalities connected with the taxation are governed by the principle of non-discrimination (prohibition of 'more burdensome' taxation). Thus, a State is prohibited from granting foreigners lower tax rates than nationals (prohibition of reverse discrimination). By contrast, if a treaty uses the expression 'other, higher or more burdensome' and we assume that 'higher' refers to the tax rate, this would imply that applying lower rates to foreign taxpayers is allowed. On the other hand, several treaties also contain the expression 'other or higher', instead of 'other or more burdensome' (e.g. Art. 24(1) of the 1959 Dutch/German treaty, which was applied in the Dutch Supreme Court case of 14 June 1972, discussed hereafter; Art. 5(1) of the 1967 Congolese/French treaty; Art. 5(1) of the 1965 French/Niger treaty; etc.). According to the IBFD Tax Treaty Database, 14 treaties (5 of which have now been terminated) contain this phrase. This wording does not fit easily with the analysis made above. Particularly, it seems unlikely that the prohibition of 'higher' taxation in these treaties can be interpreted as prohibiting 'more burdensome' formalities connected with the taxation. Even though these treaties are very uncommon and the phrase 'other or higher' seems to have fallen into disuse (the last treaty containing this phrase was signed in 1975), it should be kept in mind that every treaty requires a careful analysis of wording used in order to discover the intentions of the contracting States.

been a Ceylon resident company. The result of this comparison was that the company actually paid less tax than it would have paid, had it been a resident company[303]. As a result, the additional taxation was not 'higher or more burdensome' according to the Ceylon Supreme Court. This approach was confirmed by the Privy Council.

Thus, the question remained whether the additional tax amounted to 'other' taxation. In this regard, the Ceylon Supreme Court accepted the tax administration's argument that the extra tax levied on a non resident where there had been remittances was still income tax and nothing else. Since resident companies were also subjected to income tax, there was no 'other taxation', even though the actual measure of liability could differ between residents and non-residents.

The Privy Council however, considered that this conclusion was based on an overly narrow construction of the non-discrimination provision: *"To speak in this context of 'other' taxation must […] at least include some income tax other than the income tax to which resident companies are subjected. Resident companies are not subjected to additional income tax simply because they make remittances abroad. Non-resident companies are so subjected; and it seems to their Lordships more appropriate to the purpose of the 1950 agreement to construe this additional tax which is special to non-resident companies as 'other' taxation within the meaning of article XVIII. It follows that in their view section 53C of the 1959 Act is pro tanto in conflict with the 1950 agreement."*

Thus, in the Privy Council's view, a clear distinction is to be drawn between the prohibition of '(higher or) more burdensome' taxation and the prohibition of 'other' taxation. According to the Council, the former refers to 'the quantum of tax'[304], which *in casu* was less burdensome for the non-resident company. The latter, the prohibition of 'other' taxation, however, was violated by the domestic legislation. Since resident companies did not pay tax on remittances abroad, the tax imposed on non-resident companies was an 'other' tax, even though it was part of income tax, and even though resident companies were also subject to an additional $33^{1/3}$ % tax (on the gross amount of dividends distributed). Although the tax was in essence the same for resident companies and non-resident companies (in both cases, it concerned income tax, and in both cases the tax was imposed on profits), the fact that it was charged on a different occasion (i.e. the remittance abroad by non-resident companies) meant that it was an 'other' tax, prohibited by the treaty.

b. Dutch Supreme Court 14 June 1972[305]

a. Legal issue and the decision of the Court of Appeal

A German national was resident in Belgium and worked in the Netherlands. According to Dutch domestic tax law, non-resident employees working in the Netherlands were subject to taxation there for the salary relating to the employment exercised in the Netherlands[306]. The applicable Belgian/Dutch tax treaty provided that income from employment was taxable in the State of employment. An exception was made for frontier workers having either Belgian

[303] It should be mentioned that, in making the comparison, the Supreme Court took into account the actual dividends paid by Woodend Rubber Ltd. in the relevant years.
[304] If by 'quantum of tax' reference is solely made to the tax rate, this interpretation is probably too narrow. Whereas 'higher' most likely refers to the tax rate, 'more burdensome' does not: as argued above, the latter refers to the formalities connected with the taxation.
[305] Hoge Raad 14 June 1972, *BNB* 1973/1.
[306] Art. 48-49 I.B. 1964.

or Dutch nationality: they were only taxable in their State of residence[307]. The German taxpayer fulfilled the conditions to be a frontier worker, but he did not possess Belgian nor Dutch nationality. The Dutch tax administration therefore taxed his salary in the Netherlands in accordance with the general rule of the Belgian/Dutch tax treaty.

The taxpayer lodged an objection, arguing that he was being discriminated against on the basis of nationality. He invoked both Art. 1(1) of the Tax Arrangement for the Kingdom (TAK)[308] and Art. 24(1) of the 1959 Dutch/German tax treaty[309]. The 1933 treaty between Belgium and the Netherlands, which was applicable at the material time, did not contain a non-discrimination provision[310].

> Art. 1(1) TAK is similar to Art. 24(1) OECD MC, but it has a much wider personal scope: it covers not only nationals of the Kingdom of the Netherlands, but anybody – regardless of nationality and residence – who is subject to discriminatory taxation by any of the three countries of the Kingdom. By contrast, the discrimination provision of Art. 24(1) only covers nationals of the Contracting State. Art. 1(1) TAK provides: *"In the Netherlands, the Netherlands Antilles and Aruba, aliens are not subject to any taxation or any requirement connected therewith, which is more burdensome than that to which nationals of the Netherlands in the same circumstances are subjected."* If a foreigner is subjected to more burdensome treatment in one of the countries of the Kingdom, he can submit his claim, based on Art. 1(1) TAK, to the tax authority of the taxing State. If his claim is dismissed, he can address the issue in a court in that State.
>
> Apart from differences which are irrelevant to the present case (e.g. the wider personal scope and the use of 'more burdensome' instead of 'other or higher'[311]), Art. 1(1) TAK is identical to Art. 24(1) of the Dutch/German tax treaty. As a result, no distinction was made in the legal proceedings between the prohibition of discrimination laid down in the TAK and in the treaty.

Before the Court of Appeal, the taxpayer argued that the taxation in the Netherlands amounted to nationality discrimination, as Dutch nationals in the same circumstances (i.e. Dutch nationals, resident in Belgium, employed in the Netherlands and qualifying as frontier workers) would be treated more favourably. The tax administration replied that the non-discrimination provisions invoked by the taxpayer only applied to discrimination flowing

[307] Art. 9(1) and (2) of the 1933 treaty between Belgium and the Netherlands.

[308] The 1964 Tax Arrangement for the Kingdom ('Belastingregeling voor het Koninkrijk') is a treaty-like arrangement between the different countries of the Kingdom of the Netherlands (the Netherlands, the Netherlands Antilles and Aruba). As each of these countries has its own tax system, this Arrangement, which is based on the OECD MC, is aimed at avoiding double taxation. The TAK is a statute of the Kingdom which has effect for the entire Kingdom. National statutes, by contrast, only have effect to the country in question. The relationship between the TAK and national statutes is not addressed in the Arrangement itself, but it is widely held to be of higher rank than the national legislation of the individual countries of the Kingdom. For a more comprehensive analysis of the TAK, see A.G. GOEDKOOP and S. KLOOSTERHOF, "The non-discrimination article of the BRK", *European Taxation* 1997, 215-219.

[309] *"The nationals of one of the States shall not be subjected in the other State to any taxation which is other or higher than the taxation to which the nationals of that other State in similar circumstances are subjected. The same provision shall apply as regards the extent of any tax allowances, reliefs and reductions granted on the basis of marital status or family circumstances."* He invoked the treaty between the Netherlands and **Germany**, even though he was a resident of Belgium. Despite his non-residence in either contracting State, his claim to application of the treaty was justified, as Art. 24(1) protects **nationals** of the contracting States, and being a German national, he did qualify for this.

[310] Treaty of 20 February 1933, *Official Gazette* 26-27 August 1935.

[311] The Dutch/German tax treaty uses the phrase 'taxation which is other or higher', while the OECD MC refers to taxation which is 'other or more burdensome'. On this difference, see footnote 302.

from domestic legislation, not to discrimination flowing directly from a tax treaty. This argument is based on the fact that the discrimination at issue was not caused by Dutch domestic tax law, but by the tax treaty between Belgium and the Netherlands. Indeed, the comparison is to be made between the German taxpayer (who is subject to tax in the Netherlands) and a hypothetical Dutch national in the same circumstances (who normally would be subject to tax in the Netherlands as well, but qualifies as a frontier worker under the Belgian/Dutch treaty, with the result that he is only taxable in Belgium). Thus, the fact that the German taxpayer is taxed less favourably than his Dutch counterpart is a direct consequence of the Belgian/Dutch treaty. The tax authorities argued that such a discrimination could not be solved by Art. 1(1) TAK, nor by Art. 24(1) of the Dutch/German tax treaty[312].

The Court of Appeal ruled in favour of the tax administration. The Court based its conclusion on the following reasoning. The basic rule with regard to taxation of non-resident employees in the Netherlands is that employment exercised in the Netherlands is taxable in the Netherlands, regardless of the employee's nationality. This rule is confirmed in all tax treaties concluded by the Netherlands, including the treaty between Belgium and the Netherlands. The provision with regard to frontier workers (Art. 9(2) Belgian/Dutch treaty) is an exception to that basic rule, and this exception is no more than 'a rule of attribution' (i.e. a rule attributing the power to tax among the contracting States) according to the Court. Furthermore, Art. 9(2) of the Belgian/Dutch treaty was "not aimed at" subjecting frontier workers residing in Belgium and not disposing of Belgian or Dutch nationality to more burdensome taxation than the taxation to which Dutch nationals in the same circumstances were subject. Finally, the application *in casu* of Art. 9(1) of the Belgian/Dutch treaty (containing the basic rule of taxability in the Netherlands) was, "in fact", not discriminatory: the mere circumstance that the Dutch tax rates were, at the moment, higher than the Belgian tax rates, does not lead to the conclusion that refusing to apply Art. 9(2) *in casu* amounts to a form of prohibited nationality discrimination.

The Court thus observes that, on the one hand, the rule is **not aimed at** discriminating, and on the other hand, the rule **does not** discriminate in the case brought before the Court. The observation that Art. 9(2) of the treaty is not 'aimed at' discriminating certain frontier workers is disputable. The aim of a provision is irrelevant when assessing whether it amounts to nationality discrimination under a tax treaty. It is possible that this aim is important when assessing whether certain characteristics are relevant in the comparability-analysis, but the aim does not affect the disadvantage-test. When the effect of the rule is discriminatory, the rule falls foul of the prohibition of the disadvantage-test; the aim of the provision, no matter how commendable that aim is, cannot justify that disadvantage.

The second observation, that *de facto* no discrimination occurred, seems to avoid the actual issue. The Court holds that the higher tax rate in the Netherlands does not lead to discrimination. As a starting point, this position is certainly correct: when testing whether discrimination occurs, one must look at the tax treatment in the taxing State. The tax treatment

---

312 The 2008 update to the Comm. OECD on Art. 24 seems to offer some support for this argument in para. 4: *"the provisions of the Article must be read in the context of the other Articles of the Convention so that measures that are mandated or expressly authorized by the provisions of these Articles cannot be considered to violate the provisions of the Article even if they only apply, for example, as regards payments to non-residents. Conversely, however, the fact that a particular measure does not constitute a violation of the provisions of the Article does not mean that it is authorized by the Convention since that measure could violate other Articles of the Convention."* Interestingly, the 2008 update only refers to *"measures that are mandated or expressly authorized by the provisions of* ***these*** *Articles"*, which, in casu, would mean the Articles of the Dutch/German treaty. However, the discrimination at issue was caused by the Belgian/Dutch treaty.

in another State is, in principle, irrelevant to this assessment (see supra). However, what was at issue here was not the fact that the taxpayer was subject to a higher rate in the Netherlands, but rather the fact that he was subject to those rates **because of the application of the Belgian/Dutch tax treaty**. The discrimination *in casu* did not consist of the difference between the Belgian and the Dutch tax rates, but rather of the fact that German frontier workers employed in the Netherlands and residing in Belgium were subject to taxation in the Netherlands, whereas Dutch nationals in the same circumstances were not subject to taxation in the Netherlands[313]. When assessing whether discrimination occurs, only the treatment in the taxing State (which in the case at hand was the Netherlands) should be taken into account. The treatment in the taxing State was obviously discriminatory *vis-à-vis* the German taxpayer, as he was subjected to taxation in that State, whereas nationals of that State where not subjected to taxation at all. The problem, however, was that this differential treatment was a direct consequence of the treaty between Belgium and the Netherlands.

The real issue, therefore, was the relation between two different tax treaty provisions: Art. 9(1) of the Belgian/Dutch treaty (which attributed taxing power over the employment income to the Netherlands) and Art. 24(1) of the Dutch/German treaty (which prohibited the Netherlands from taxing German nationals less favourably than Dutch nationals). Implicitly, however, the Court does address this issue: by stressing that Art. 9(2) of the treaty is a rule of attribution, the Court seems to suggest that the mere application of such rules of attribution cannot lead to nationality discrimination. Thus, the mere division of taxing jurisdiction among contracting States cannot give rise to discrimination; only when a State **exercises** the jurisidiction so divided in a discriminatory manner, can the non-discrimination provision come into play. This reasoning, which is very similar to the line of reasoning followed by the

[313] The taxpayer came to a similar conclusion, but on the basis of different arguments. He held that discrimination consists of treating two groups differently; it does not consist of the consequences of such differential treatment. The taxpayer argued that the substance of the non-discrimination concept is neutral, i.e. that any differential treatment on the basis which is prohibited by the provision (*in casu* nationality) leads to a violation of the provision, regardless of whether the consequences of such differential treatment are to the benefit or to the detriment of the taxpayer. However, in my opinion, the consequences of the differential treatment must not be ignored. By denying the relevance of the consequences, the taxpayer equates the principle of non-discrimination with the principle of equality. As mentioned above, the principle of equality requires two situations to be treated identically. Differential treatment among the groups in issue is prohibited, regardless of whether this treatment would be disadvantageous for the 'protected' group (the subject of comparison). Non-discrimination, on the other hand, is concerned with differential treatment which is more burdensome or has adverse effects on the protected group. As a result, the principle of non-discrimination is not 'neutral': the differential treatment, *in casu* on the basis of nationality, must have adverse effects for the subject of comparison. *In casu* there was discrimination: German frontier workers employed in the Netherlands and residing in Belgium were treated differently in the Netherlands than Dutch nationals in the same circumstances, and this difference in treatment amounted to a taxation which was more burdensome. Despite this semantic inaccuracy, there is something to be said for the taxpayer's argument. As discussed above, it seems that the taxable basis, the assessment method and the tax rate are governed by the principle of equality (prohibition of 'other' taxation), whereas the obligations relating to the formalities connected with the taxation are governed by the principle of non-discrimination (prohibition of 'more burdensome' taxation). In the present case, the subject of comparison was subject to 'other tax rates', i.e. the tax rates applicable in the Netherlands, while the object of comparison was subject to the tax rates applicable in Belgium. Regardless of which of these rates was higher, the equality principle embodied in the prohibition of 'other taxation' precludes such differentiation. However, the Supreme Court did not address this aspect of the taxpayer's argumentation because it held that Art. 9(1) of the Belgian/Dutch treaty could not be tested against the relevant non-discrimination provisions (see hereafter). Moreover, the German/Dutch tax treaty did not refer to 'other or more burdensome taxation', but to 'other or higher taxation'. As discussed in footnote 302, it is difficult to reconcile this wording with the distinction between, on the one hand, the taxable basis, the assessment method and the tax rate (governed by the principle of equality) and, on the other hand, the formalities connected with the taxation (governed by the principle of non-discrimination).

ECJ[314], does not solve the conflict between the two treaty provisions by giving precedence to either provision, but rather by denying that they conflict with one another in the first place.

b. The decision of the Supreme Court

The taxpayer appealed to the Supreme Court. The Supreme Court dismissed the appeal, by stating that the provisions invoked by the taxpayer (i.e. the non-discrimination provisions of the TAK and the Dutch/German tax treaty), *"do not affect the freedom of the Netherlands to agree with another State by means of a treaty that, with regard to certain groups of nationals of either State, the tax which in principle could be levied by one State, is left to the other State"*[315].

At first sight, the Supreme Court seems to confirm, quite concisely, the Court of Appeal's view that the non-discrimination provisions do not form an obstruction to the application of 'attribution rules', simply because they do not conflict with one another. The Supreme Court's decision is, however, not entirely satisfactory. By merely stating that the non-discrimination provisions 'do not affect' the freedom of the Netherlands to divide taxing powers with regard to specific items of income by means of a tax treaty, the relationship between the attribution rules of a tax treaty and the non-discrimination rules of the treaty (or those of another treaty) is not clarified. Is the conclusion based on the argument that both provisions simply cannot conflict (as the Court of Appeal seemed to argue), or rather on the argument that the rules of allocation take precedence over non-discrimination rules (for instance, because they are a *lex specialis*)? It is unclear from the Supreme Court's use of words which approach it favours.

In the end, however, the result is the same for the taxpayer seeking to alleviate the discriminatory tax treatment: the taxing State is not precluded from subjecting the foreigner to more burdensome taxation than its own nationals. The rules of attribution are applied, and the non-discrimination provisions do not hinder such application (nor do they obstruct the consequences of that application, i.e. taxation in the Netherlands). Whether this absence of obstruction is due to an absence of a conflict, or to a prevalence of the attribution rules is irrelevant to the final result[316].

---

[314] The ECJ makes a similar distinction. See, for instance, C-307/97, *Saint Gobain*, 21 September 1999, § 56-57: *"in the absence of unifying or harmonising measures adopted in the Community […], the Member States remain competent to determine the criteria for taxation of income and wealth with a view to eliminating double taxation by means, inter alia, of international agreements. In this context, the Member States are at liberty, in the framework of bilateral agreements concluded in order to prevent double taxation, to determine the connecting factors for the purposes of allocating powers of taxation as between themselves […]. As far as the exercise of the power of taxation so allocated is concerned, the Member States nevertheless may not disregard Community rules. According to the settled case-law of the Court, although direct taxation is a matter for the Member States, they must nevertheless exercise their taxation powers consistently with Community law."*

[315] My translation, NB. The original text was: *"dat de bepalingen, waarop belanghebbende zich beroept ter staving van zijn standpunt, dat het opleggen van de onderhavige aanslag te zijnen opzichte een discriminatie inhoudt op het stuk van de heffing van inkomstenbelasting, onverlet laten de vrijheid van Nederland om bij verdrag met een andere staat overeen te komen, dat met betrekking tot bepaalde groepen van personen van de nationaliteit van een der beide Staten de heffing van een belasting, die in beginsel door de ene staat zou kunnen worden geheven, aan de andere Staat wordt overgelaten"*.

[316] Another case dealing with discrimination originating in a tax treaty was decided by the Brussels Court of First Instance in 2006. As this case concerned application of the non-discrimination provision on permanent establishments, I will discuss it later (see infra, 2.D.III.C.e.2). See also the discussion of the *Metchem Canada* case, in 2.D.III.C.e.1.

Neither of these approaches seems entirely convincing. First, as regards the idea that a conflict between rules of allocation and non-discrimination provisions is impossible because of the very nature of allocation rules, it should be noted that the parallel with the ECJ's case law is not entirely correct. The basis of the ECJ's case law, referred to above, is that Member States remain free to allocate powers of taxation between themselves. Given their sovereignty in direct tax matters and the absence of harmonising measures, the Member States remain competent to determine criteria for allocating tax jurisdiction. That is the reason why the ECJ cannot judge on the compatibility of such measures with the fundamental freedoms (and, hence, their discriminatory character). Measures allocating taxing powers may very well be discriminatory, but the ECJ is simply unable to assess their compatibility with EU law because of Member States' sovereignty.

That line of reasoning cannot be transposed to tax treaty law. There is nothing to prevent a court from deciding that a rule allocating taxing powers is discriminatory (leaving aside, for the moment, on what legal basis that discrimination can be challenged). Suppose, for instance, that the tax treaty between State A and State B expressly provides that State A may levy withholding taxes up to 15% as regards dividends paid to State A nationals residing in State B, while that same State A may levy withholding taxes up to 25% as regards dividends paid to State B nationals residing in State B. Such a rule, which allocates taxing powers in respect of dividend payments, clearly discriminates on the basis of nationality. Assuming that tax treaty provisions are subject to a non-discrimination rule (a question which will be addressed later), the distinction between both types of dividend payments clearly falls foul of that rule. In other words, it is incorrect to argue that tax treaty rules allocating taxing powers are, by definition, not discriminatory. In the context of EU tax law, it is correct to say that tax treaty rules allocating taxing powers are, by definition, not incompatible with the fundamental freedoms. Yet, that is not because they or not discriminatory, but simply because they fall outside the scope of those freedoms.

That being said, the question remains whether discrimination caused by provisions of a tax treaty can be considered to violate the non-discrimination provision of that same treaty. This concerns the second approach suggested above: if there is a possible conflict between rules allocating taxing powers and the non-discrimination rules, it falls to be determined which takes precedence over the other. In this regard, it is necessary to try and find the common intention of the treaty partners when drafting the treaty. When interpreting Article 24 of the treaty, it is necessary to take account of the context of that provision, which includes the other provisions of the treaty[317]. Where the treaty partners expressly include measures in the treaty that discriminate, their common intention to do so cannot be ignored by relying on the non-discrimination provision of the treaty. The same applies where the treaty partners expressly preserve domestic measures that discriminate in the treaty: if it was the treaty partners' intention to uphold such discriminatory treatment, the non-discrimination provision cannot remedy this discrimination[318]. In that respect, one could speak of a *lex specialis*, in that the

[317] See Art. 31(2) of the Vienna Convention. See also Comm. OECD on Art. 24, para. 4, referred to above.

[318] See infra, 2.D.III.C.e.1, on the *Metchem Canada* case. For another example, see Point 5 of the Protocol to the 1995 treaty between Belgium and Spain, which provides as follows: *"It is understood that the provisions of Article 24: (a) shall not prevent the Contracting States from applying their internal law regarding undercapitalization; (b) shall not prevent a Contracting State from subjecting the profits of a permanent establishment available to a company being a resident of the other Contracting State in the first- mentioned State, to tax at a rate provided by its internal law, provided that the rate mentioned shall not exceed the maximum rate applicable to the profits of companies which are residents of the first-mentioned State; (c) shall not prevent Belgium, under the conditions laid down in its legislation, from imposing the movable prepayment*

general prohibition of discrimination is superseded by an express exception thereto: the treaty partners clearly show their intention to deviate from the general rule postulated elsewhere in the treaty. The reason, however, that one rule is a *lex specialis* while the other is *generalis* is not inherent in their nature (i.e. that rules of allocation are, by their very nature, *lex specialis* as regards non-discrimination rules). Rather, the rule at issue is a *lex specialis* because, in this specific instance, the treaty partners have demonstrated their desire to deviate from the non-discrimination rule.

Nevertheless, that solution only concerns situations where the non-discrimination provision of a tax treaty is invoked in respect of discriminatory treatment caused by the provisions of that same treaty. The case before the Dutch Supreme Court concerned the relevance of the non-discrimination provision in a tax treaty as regards benefits provided for in another tax treaty. In that regard, one could argue that no object of comparison can be found, with the result that the comparison is impossible. The reasoning would be that a German frontier worker employed in the Netherlands and residing in Belgium would never be in the same circumstances as a Dutch frontier worker, because Dutch frontier workers fall under the personal scope of the Belgian/Dutch tax treaty, and German frontier workers do not. As such, the applicability of the Belgian/Dutch treaty to the Dutch frontier workers would render the comparison impossible, as the circumstances are not the same.

Yet, it could be counter-argued that differences which are a direct consequence of the difference in nationality must be ignored when assessing whether the situations are comparable (see supra), and the applicability of Art. 9(2) of the Belgian/Dutch treaty is based exactly on the nationality of the Dutch frontier workers. Once again, the problem is that it is the treaty which attaches consequences to nationality, not domestic law. In the examples given in 2.B.V.A, it was domestic tax law which attached consequences to nationality (e.g. full tax liability in the U.S.). Moreover, the inapplicability of Art. 9(2) to the subject of comparison was exactly the discrimination that was at issue, so it cannot be used as an argument for incomparability. Assuming that the applicability of the discriminating measure to one group of taxpayers renders them incomparable to another group to which the measure does not apply would mean that a measure can never discriminate as the situations are never comparable.

The more elegant solution would have been for the Supreme Court to simply hold that benefits provided for by a tax treaty with a third State are by their very nature reciprocal, and consequently do not form part of the national treatment to which a foreign taxpayer is entitled under a non-discrimination provision (in the present case, under the TAK or the Dutch/German treaty)[319]. In the present case, the relevant benefit was the frontier worker regime provided for by the Belgian/Dutch treaty, which was restricted (on a reciprocal basis) to nationals of either contracting State. Discrimination consists of denying a certain benefit to the subject of comparison, while at the same time granting it to the object of comparison. In the present case, the Belgian/Dutch treaty granted this benefit to nationals of either contracting State, on the basis of reciprocity. As a result of this reciprocal nature, the benefit

---

on dividends derived from a holding of less than 25% which is effectively connected with a permanent establishment situated in Belgium of a company which is a resident of Spain."

[319] See also Comm. OECD on Art. 24, para. 2: *"As tax conventions are based on the principle of reciprocity, a tax treatment that is granted by one Contracting State under a bilateral or multilateral agreement to a resident or national of another Contracting State party to that agreement by reason of the specific economic relationship between those Contracting States may not be extended to a resident or national of a third State under the non-discrimination provision of the tax convention between the first State and the third State."*

cannot be extended to nationals of a third State. In other words, benefits granted under a tax treaty to nationals of the contracting State cannot be extended to nationals of third States on the basis of the non-discrimination provision in another tax treaty; not because 'attribution rules' take precedence over discrimination rules, but simply because tax treaty benefits are granted on a reciprocal basis and are, therefore, limited to nationals (or residents, depending on the treaty) of the contracting States.

This whole issue is obviously connected to the MFN-issue, discussed in 2.A. Assuming that a tax treaty non-discrimination provision entitles its beneficiaries to treaty benefits provided for under tax treaties with third States would be tantamount to recognizing an implicit MFN-clause in tax treaty non-discrimination provisions. Clearly, the taxpayer in the present case did not claim MFN-treatment. He did not claim the same treatment as that accorded to nationals of the 'most favoured' State. Rather, he claimed benefits provided for to nationals of the discriminating State under a treaty with a third State. That is not a matter of MFN, but it should be dismissed for the same reason. As tax treaties grant benefits on a reciprocal basis, their effect is relative. As a result, the benefits they grant cannot be extended to nationals of third States: this simply goes beyond the scope of non-discrimination provisions.

c. Bundesfinanzhof 14 March 1989[320]

A somewhat similar issue arose in a Bundesfinanzhof decision of 1989. A national of the Netherlands who was a resident of Germany worked in Italy for five days on behalf of a German employer. The German tax administration levied income tax on the entire amount of the taxpayer's employment income. If the taxpayer had been a German national, he would be entitled to an exemption from income tax in Germany in respect of the employment income earned in Italy. This exemption was based on Art. 7(1) and Art. 11(1) of the 1925 treaty between Germany and Italy[321]. According to the taxpayer, he should also be entitled to the exemption under the Italian/German treaty. In order to support this argument, the taxpayer relied on the non-discrimination provision in the treaty between Germany and the Netherlands (i.e. the same provision relied on by the taxpayer in the 1972 decision of the Dutch Supreme Court, discussed above).

According to a majority of German case law, the treaty between Germany and Italy only applied to German and Italian nationals, not to third country nationals residing in either State[322]. Nevertheless, the Bundesfinanzhof decided that the taxpayer could rely on the non-discrimination provision in the Dutch/German treaty in order to claim the exemption under the Italian/German treaty. The Bundesfinanzhof noted that the non-discrimination provision in the Dutch/German treaty prohibited tax disadvantages that were determined solely on the basis that the taxpayer had the nationality of the Netherlands. That provision guaranteed that Dutch nationals residing in Germany were directly entitled (*"gewährt […] einen*

[320] Bundesfinanzhof 14 March 1989, BStBl II 1989, 649.
[321] Art. 7(1) of the treaty provided: *"Impersonal taxes which are levied on income from labour including income from liberal professions shall only be imposed in the State in which the personal activity from which such income is derived is carried on […]"*. Art. 11(1) of the treaty provided: *"Personal taxes levied on the taxpayer's aggregate income shall be imposed by each of the Contracting States in accordance with the following provisions: Income from: […] labour, including remuneration paid by public bodies shall be subject to the same provisions laid down for these categories of income in the respective articles"* (treaty between Germany and Italy of 31 October 1925, as translated in the IBFD Tax Treaty Database).
[322] See the references in Bundesfinanzhof 14 March 1989, § 9. See also R. BETTEN, "Italy – Germany Tax Treaty. Applicability of the treaty to a German resident Dutch national", *European Taxation* 1990, 53-54.

unmittelbaren Anspruch") to all exemptions to which a German national residing in Germany was entitled in similar circumstances, including the exemptions resulting from the Italian/German tax treaty.

According to the Bundesfinanzhof, Art. 24 of the Dutch/German treaty encompasses the whole range of formal and substantive tax law[323]. As a result, Dutch nationals residing in Germany were entitled to all tax benefits to which German nationals residing in Germany were entitled in similar circumstances. This includes the application of the provisions of the German/Italian treaty, as these provisions function as objective exemptions, insofar as they provide for the non-taxation of income in Germany[324].

It seems hard to reconcile this position with the general principle that tax treaties have a relative effect, as the Bundesfinanzhof's argument apparently amounts to the construction of an MFN-clause in the non-discrimination provision. As I have indicated earlier, such an approach should be rejected. Yet, the Bundesfinanzhof denies that this interpretation leads to an expansion of the non-discrimination provision to encompass an implicit MFN-clause: *"[This interpretation] does not mean that the prohibition of discrimination will function as a most favoured nation clause. The standard of comparison of equal circumstances significantly restricts such functioning. A different tax on Netherlands nationals will still be permissible, if it is based on grounds which are beyond the equal circumstances"*[325].

In other words, the Bundesfinanzhof holds that its interpretation of Art. 24 does not imply a requirement of MFN-treatment, because of the comparability-test inherent in the discrimination-analysis. A national of the Netherlands can still be denied tax benefits (including benefits provided for in a tax treaty with a third State) if he is incomparable to a German national who is entitled to those benefits. In my opinion, that argument is not very convincing. As mentioned earlier, the main difference between a non-discrimination provision and a MFN-provision lies in the object of comparison: while a non-discrimination requires the taxpayer to be compared to a national or resident of the (allegedly) discriminating State, a MFN-provision requires a comparison to nationals or residents of a third State (i.e. the 'most favoured' State). The requirement that the relevant circumstances must be the same is also inherent in MFN-clauses: MFN-treatment is not granted to all taxpayers, but only to those taxpayers that are comparable to residents of third States who are entitled to those benefits.

Nevertheless, it is clear that the grant of the exemption to the taxpayer in the present case did not amount to granting him MFN-treatment in the strict sense[326]. The Bundesfinanzhof's decision did not imply that the taxpayer was entitled in Germany to the same treatment as the treatment accorded to a national of the most-favoured State in the same circumstances. Instead, the taxpayer was entitled to treatment to which a German national in the same

---

[323] *"Das Diskriminierungsverbot des Art.24 DBA-Niederlande umfaßt den gesamten Bereich des formellen und materiellen Besteuerungsrechts."*

[324] *"Die in der Bundesrepublik ansässigen Niederländer haben deshalb hier Anspruch auf alle Steuerbefreiungen, Steuervergünstigungen und Steuerermäßigungen, die einem hier ansässigen deutschen Staatsangehörigen unter sonst gleichen Verhältnissen zu gewähren sind. Dies schließt die entsprechende Anwendung der Vorschriften des DBA-Italien ein, weil diese, soweit sie die Nichtbesteuerung von Einkünften im Inland anordnen, als sachliche Steuerbefreiung wirken."*

[325] *"Die vom erkennenden Senat nunmehr vertretene Auffassung bedeutet nicht, daß das Diskriminierungsverbot im Sinne einer Meistbegünstigungsklausel wirken würde. Der Vergleichsmaßstab gleicher Verhältnisse schränkt diese Wirkung deutlich ein. Eine ungleiche Besteuerung niederländischer Staatsangehöriger bleibt stets erlaubt, wenn sie sich aus Gründen ergibt, die außerhalb gleicher Verhältnisse liegen."*

[326] See also supra, on the similar issue arising in the Dutch Supreme Court case of 1972.

circumstances was entitled, including benefits laid down in a tax treaty with a third State. Even though this is not the same as MFN-treatment, it should be denied for the same reason: the relative effect of tax treaties. In the present case, this relative effect did not only mean that the taxpayer should not be entitled to benefits granted by the German/Italian treaty to Italian nationals, but also that he should not be entitled to benefits granted by that treaty to German nationals. The benefits of the German/Italian treaty are granted to nationals of those two States on the basis of reciprocity. This reciprocity, and the balance of the tax treaty which results therefrom, would be undermined if nationals of third States could claim the same benefits on the basis of a non-discrimination provision in another treaty.

d. Conseil d'Etat 28 May 1986[327]

An interesting decision on the interpretation of 'other or more burdensome' was given by the French Conseil d'Etat in 1986. The taxpayer was a German national who resided in France. He paid a maintenance allowance to his former spouse, who resided in Germany. Under French tax law at the material time, maintenance allowances were only deductible for individual income tax purposes if they were paid in fulfillment of a judicial decision. As the maintenance allowance in the present case had been mutually agreed upon by the taxpayer and his former spouse, without judicial intervention, it was not deductible in France.

However, the taxpayer noted that **in Germany**, maintenance allowances mutually agreed upon by the parties were deductible for tax purposes. He relied on the non-discrimination provision of the French/German tax treaty in order to claim deductibility in Germany[328]. The reasoning behind this argument was that French nationals residing in Germany were entitled to deduct these maintenance allowances. Accordingly, the taxpayer argued that German nationals residing in France should also be entitled to the deduction. In other words, the taxpayer argued that the non-discrimination provision entitled German nationals to the same treatment in France as the treatment accorded in Germany to French nationals. Obviously, this comparison is incorrect as both groups are in different circumstances with respect to residence (German nationals residing in France cannot be compared to French nationals residing in Germany). However, the Conseil d'Etat dismissed the argument on other grounds. According to the Conseil d'Etat, the French legislation at issue did not subject German nationals to treatment that was other or more burdensome than the treatment to which it subjected French nationals[329]. In other words, there was no discrimination because the legislation did not differentiate on the basis of nationality.

Ultimately, however, the reasoning followed by the Court and the argument that the situations were incomparable, are two different ways of saying the same thing. What the Court does is replace the comparison made by the taxpayer (which was invalid) by the correct comparison, i.e. a comparison between a German national residing in France (subject of comparison) and a French national residing in France (object of comparison). As the French legislation at issue did not subject the subject of comparison to treatment that was other or less favourable than the treatment to which it subjected the object of comparison, there was no discrimination.

[327] Conseil d'Etat 28 May 1986, No. 49307, Droit Fiscal 1987, No. 49, Com. 2181.
[328] Art. 21(1) of the 1959 treaty between France and Germany, which was identical to Art. 24(1) of the 1963 OECD Draft Convention (see supra).
[329] The original text of the judgment was: *"l'application aux nationaux de cet Etat des dispositions précitées […] n'a pas pour effet de les soumettre à des obligations autres ou plus lourdes que celles qui découlent pour les Français de l'application des mêmes dispositions"*.

VII. Reciprocity

VII.A. General

Even though no such condition is expressed in the text of Art. 24(1), the OECD Commentary indicates that the non-discrimination rule contained therein is subject to reciprocity[330]. It is not immediately clear, however, what is meant by this statement.

The concept of reciprocity meanders through public international law, but its precise meaning is difficult to establish[331]. The Vienna Convention on the Law of Treaties (VC) makes no express mention of reciprocity. The VC approaches treaties as agreements between mutually consenting parties. The mutual element, however, does not necessarily imply that the obligations which States agree to uphold are subject to reciprocity.

'Reciprocity' refers to the relational framework which is constructed by the mutual agreement; the rights and obligations of one contracting State are thus directly linked to those of the other contracting State. Taking into account an underlying concept of reciprocity, a bilateral treaty can thus be defined as the expression of a mutual, but conditional, exchange of legal rights and obligations, in which the rights and obligations of one contracting State are directly linked with the rights and obligations of the other contracting State. The concept of reciprocity embodies the underlying *quid pro quo*, the conditionality of a contracting State's adherence to treaty obligations upon the adherence to those obligations by the other contracting State. Reciprocity indicates that a contracting State's treaty obligations are measured by the other State's application of that treaty.

Non-discrimination provisions in Treaties of Commerce and Navigation (which probably served as an inspiration to Art. 24 OECD MC; see supra) often refer expressly to reciprocity[332]. Furthermore, several unilateral non-discrimination measures are expressly made subject to the requirement of reciprocity. For instance, in the 1920's, Section 222 of the U.S. Revenue Act provided that a U.S. citizen was entitled to credit his Federal income tax with the amount of income, war-profits or excess-profits taxes paid or accrued during the taxable year to any foreign country. The same credit was granted to aliens residing in the U.S.

---

[330] Comm. OECD on Art. 24, para. 5.

[331] The role of reciprocity can be linked with the ongoing development of international law. As SIMMA notes: *"As long as the international legal order lacks a centralized enforcement machinery and thus has to live with autodetermination and self-help, reciprocity will remain the principle leitmotiv, a constructive, mitigating and stabilizing force, the importance of which can hardly be overestimated."* B. SIMMA, "Reciprocity", in R. BERNHARDT, *Encyclopedia of Public International Law, Vol. 7*, Amsterdam, 1992, 400

[332] E.g. Art. II of the Treaty of Commerce and Navigation between Austria-Hungary and the United States of America of 27 August 1829: *"Austrian vessels arriving, either laden or in ballast, in the ports of the United States of America, and, reciprocally, vessels of the United States arriving, either laden or in ballast, in the ports of the dominions of Austria, shall be treated on their entrance, during their stay, and at their departure, upon the same footing as national vessels coming from the same place, with respect to […] all […] duties or charges"*, W. MALLOY, *Treaties, Conventions, International Acts, Protocols and Agreements Between the United States of America and other powers. 1776-1909*, Washington, U.S. Government Printing Office, 1910, 30; Arts. II-III of the Treaty of Commerce and Navigation between Belgium and the United States of America of 10 November 1845: *"Belgian vessels, whether coming from a Belgian or a foreign port, shall not pay, either on entering or leaving the ports of the United States, whatever may be their destination, any other or higher duties […] than are required from vessels of the United States in similar cases. […] Reciprocally, vessels of the United States, whether coming from a port of said States or from a foreign port, shall not pay, either on entering or leaving the ports of Belgium, whatever may be their destination, any other or higher duties […] than are required from Belgian vessels in similar cases"*, W. MALLOY, *o.c.*, 65.

"if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country". As American citizens residing in Sweden were not entitled to such credits in Sweden, Swedish nationals residing in the U.S. were not entitled to the benefit of the credit. Sweden tried to remedy this situation by promulgating a Royal Decree extending to U.S. citizens residing in Sweden tax treatment which is similar to that enjoyed by Swedish subjects[333].

Thus, it seems that non-discrimination clauses in tax treaties are often, by their very nature, reciprocal[334]. Indeed, the reason why one State agrees to accord subjects of another State non-discriminatory treatment, is the desire of reciprocity, i.e. that the other State will treat the first State's subjects in a non-discriminatory manner. Thus, clauses granting non-discriminatory tax treatment are usually reciprocal, and sometimes even expressly stipulate reciprocity as a condition[335]. The rare instances of non-reciprocal clauses granting non-discriminatory tax treatment to the subjects of another State are concerned with a problem arising in one State only[336].

Nevertheless, the implications of the principle of reciprocity are not always clear. More specifically: what would happen if one State does not adhere to its obligations under the treaty? A first possible interpretation would be that reciprocity allows a State that feels its

---

[333] See the diplomatic correspondence on this matter between the Swedish Minister of Foreign Affairs and the U.S. Secretary of State, *Foreign Relations of the United States*, 1928, vol. iii, 885-893.

[334] Some confusion may arise here because reciprocal treatment is sometimes considered side by side with the principle of non-discrimination as one of the three main methods used to prevent cross-border activities being unduly burdened (for instance with taxes) *vis-à-vis* interstate activities (the third method being MFN-treatment); e.g. A. R. ALBRECHT, "The taxation of aliens under international law", *British Yearbook of International Law* 1952, 150 *et seq.*; J. W. CUTLER, "The treatment of foreigners", *American Journal of International Law* 1933, 225 *et seq*. See also H. J. AULT, "Corporate integration, tax treaties and the division of the international tax base: principles and practices", *Tax Law Review* 1991-92, 568 *et seq.*, who suggests that the OECD MC uses the principle of non-discrimination to limit the ability of the source State to tax business income (notably in Art. 24(3) and (6) OECD MC), whereas the principle of reciprocity is used in order to limit the ability of the source State to tax investment income (by setting fixed withholding rates in Arts. 10-12 OECD MC, which are to be applied by both States). This apparent inconsistency is not problematic: as I will argue, the concept of reciprocity underlies most (if not all) tax treaties. As reciprocity inspires the entire tax treaty, it will influence the non-discrimination provision as well. While it is true that both reciprocity and non-discrimination may theoretically be used to guarantee a certain standard of treatment in bilateral instruments, this does not detract from the inherent presence of reciprocity in the whole of the tax treaty and, consequently, in the non-discrimination provision thereof.

[335] E.g. the Convention respecting conditions of residence and business and jurisdictions of 24 July 1923 (which was part of the Lausanne Convention), between Turkey on the one hand, and the British Empire, France, Italy, Japan, Greece, Romania and Serbia (i.e. the majority of the Allied Powers during WW I) on the other hand, *Supplement to the American Journal of International Law*, vol. 18, 1924, 67 and 70. This convention protected nationals of the contracting States other than Turkey from any tax or charge *"other or higher than those which may be imposed on Turkish nationals"* (Art. 8). Pursuant to Article 1 of the Convention, the application of this provision was *"expressly subject to complete reciprocity being accorded to Turkish nationals and corporations in the territories of the said Powers"*. The express reference to reciprocity in this treaty may perhaps be explained by the fact that certain provision of the convention are not subject to reciprocity (e.g. the non-reciprocal grant of the right for non-Muslim nationals of the Allied Powers in Turkey to apply to courts in their own countries for the adjucation of matters involving their personal status, succession, family law, etc.).

[336] For instance, the 1948 Agreement between Guatemala and the U.S. on the Inter-American highway provided that Guatemala could not levy taxes on the use of the Guatemalan part of highway if those taxes did not apply equally to the use of the highway by Guatemalan vehicles (Agreement between the United States and Guatemala of 18 May 1948, amending the Agreement of 19 May 1943, C. BEVANS, *Treaties and Other International Agreements of the United States of America 1776-1949*, Vol. 8, Washington, U.S. Government Printing Office, 1968, 596). Since this obligation only concerned the Guatemalan part of the highway, it was clear that the obligation was not reciprocal.

subjects are being discriminated against, to retaliate against the subjects of the discriminating State. In other words, if State A feels that its nationals are being discriminated against in State B, reciprocity would mean that State A is entitled to retaliate against State B by applying more burdensome taxation to State B nationals[337]. So a violation of the non-discrimination clause by one contracting State would mean that the other contracting State is no longer required to observe the non-discrimination clause itself. From that perspective, the non-observance by the first contracting State could be seen as a 'material breach' of the treaty within the meaning of Article 60 VC, which allows the other contracting State to suspend its own obligations in part (i.e. its own obligations pursuant to the non-discrimination clause)[338]. However, Art. 60 VC does not allow the adversely affected State to unilaterally and directly suspend or terminate the treaty. Instead, that provision merely allows the innocent State to **invoke** the breach as a ground for suspension or termination. As a result, that State must pursue its rights within the framework of Articles 65 to 68 VC (i.e. a written notification, a possible procedure before the ICJ, etc.). Suspension or termination may then be the result of that procedure[339].

So the concept of reciprocity does not mean that a contracting State can set aside the prohibition of discrimination included in its tax treaty with another State, simply because that other State has violated that prohibition. Rather, a more nuanced approach is preferable, which is also what the (rare) case law dealing with this issue suggests.

VII.B. Case law

a. American Trust Company[340]

A U.S. trust realized capital gains on the sale of assets. Article XIV of the 1945 U.K./U.S. treaty provided that U.K. residents who were not engaged in a trade or business in the U.S. were exempt from U.S. tax on gains from the sale of capital assets. The U.S. trustee relied on that provision to argue that the capital gains were exempt from tax in the U.S. because all the beneficiaries of the trust were residents of the U.K. The U.S. tax authorities took the position

[337] As an example of such 'retaliatory discrimination' (which, however, does not refer to the reciprocal nature of tax treaties), see § 891 of the U.S. Internal Revenue Code: *"Whenever the President finds that, under the laws of any foreign country, citizens or corporations of the United States are being subjected to discriminatory or extraterritorial taxes, the President shall so proclaim and the rates of tax imposed by sections 1, 3, 11, 801, 831, 852, 871, and 881 shall, for the taxable year during which such proclamation is made and for each taxable year thereafter, be doubled in the case of each citizen and corporation of such foreign country; but the tax at such doubled rate shall be considered as imposed by such sections as the case may be. In no case shall this section operate to increase the taxes imposed by such sections (computed without regard to this section) to an amount in excess of 80 percent of the taxable income of the taxpayer (computed without regard to the deductions allowable under section 151 and under part VIII of subchapter B). Whenever the President finds that the laws of any foreign country with respect to which the President has made a proclamation under the preceding provisions of this section have been modified so that discriminatory and extraterritorial taxes applicable to citizens and corporations of the United States have been removed, he shall so proclaim, and the provisions of this section providing for doubled rates of tax shall not apply to any citizen or corporation of such foreign country with respect to any taxable year beginning after such proclamation is made."* A similar provision is contained in § 896 I.R.C.

[338] Art. 60(1) Vienna Convention: *"A material breach of a bilateral treaty by one of the parties entitles the other to invoke the breach as a ground for terminating the treaty or suspending its operation in whole or in part."*

[339] M. VILLIGER, *Commentary on the 1969 Vienna Convention on the Law of Treaties*, Leiden, Martinus Nijhoff, 2009, 739-742. See also J. WOUTERS and M. VIDAL, "The international law perspective", in G. MAISTO (ed.), *Tax treaties and domestic law*, Amsterdam, IBFD, 2006, 32-34.

[340] U.S. Court of Appeals for the Ninth Circuit 8 July 1957, *American Trust Company v. James G. Smyth, Collector of Internal Revenue and United States*, 247 F.2d 149 (9 Cir. 1957)

that Article XIV of the treaty did not apply because the capital gains were retained by the trust rather than distributed to the beneficiaries.

The issue at stake was thus whether the exemption under Art. XIV of the treaty applied to the trust, or rather to the beneficiaries thereof. The U.S. tax authorities argued that the trust was a separate taxable entity under U.S. domestic tax law. The capital gain resulting from the sale of trust property was not income of the beneficiaries, but was income taxable to the trust. The trustee took the position that Art. XIV of the treaty prevented not only taxation on the capital gain upon the U.K. beneficiaries, but also taxation upon the trust retaining the gain, notwithstanding the absence of a current distribution. The Court ruled in favour of the taxpayer, on the basis of reciprocity. The Court stated: *"We conceive the purpose of the Treaty to have been full reciprocity and equality of tax treatment between nationals of the United States and the United Kingdom. Such being the case, this purpose requires a broad construction of Article XIV, so as to relieve the British beneficiaries from the burden of the capital gains tax to the same extent, in a given situation, as a United States beneficiary would be in a similar position in the United Kingdom."*

Although the trust was treated as a separate taxable entity under U.S. domestic tax law, the Court held that the purpose of the treaty (securing reciprocity and equality of tax treatment between the nationals of the U.K. and the U.S.) prevented the U.S. tax authorities from applying this approach *in casu*. Then, the Court turns to Art. II(3) of the treaty, which provides that a term not defined in the treaty, shall have the meaning *"which it has under the laws of that Contracting Party relating to the taxes which are the subject of the present Convention"*, unless the context requires otherwise.

As the term 'exempt' was not defined in the treaty, nor in U.S. domestic tax law, the Court tries to construe the term *"in accordance with the intent of the contracting parties, in order to achieve reciprocity between similarly situated United States and United Kingdom taxpayers."* The Court found that 'exempt' was used in its broadest meaning, signifying a release from economic burden. If the capital gains tax were to be imposed on the trust, the U.K. beneficiaries would be economically burdened with the U.S. tax, as it diminished their respective incomes and corpus distributions. According to the Court, the contracting States did not intend such an economic burden to be placed on U.K. taxpayers, when in a similar situation a U.S. beneficiary would not have a similar burden arising from U.K. taxation. The Court continues: *"A study of the Articles of the Convention indicates an attempt to achieve a thoroughgoing reciprocity between the two nations' taxpayers in similar situations. Upon its face Article XIV does not portray any concession by the United Kingdom. The policy of reciprocity is apparent, however, when it is realized that the United Kingdom does not impose an income tax upon capital gains; it is obvious there was no occasion for any express concession on this point by it."*

Finally, reference is made to the absence of a savings clause in the treaty[341]. The purpose of such a clause is to make plain that the U.S. reserved the right to include all items of income

[341] The Court refers to Art. XIV of the 1940 Swedish/U.S. treaty, which contains a "typical savings clause": *"It is agreed that double taxation shall be avoided in the following manner: Notwithstanding any other provision of this convention, the United States of America in determining the income and excess-profits taxes, including all surtaxes, of its citizens or residents or corporations, may include in the basis upon which such taxes are imposed all items of income taxable under the revenue laws of the United States of America as though this Convention had not come into effect. The United States of America shall, however, deduct the amount of the taxes specified in Article I(b) (1) and (3) of this Convention or other like taxes from the income tax thus computed but not in excess of that portion of the income tax liability which the taxpayer's net income taxable in Sweden bears to his*

taxable under its revenue laws. According to the Court, the savings clause is incorporated into certain treaties with the express purpose of limiting exemptions. Its omission from the U.K./U.S. treaty *"is further evidence of a purpose to exempt completely income from capital gains belonging to residents of the United Kingdom, regardless of where lodged between the time of receipt and distribution."* Thus, the Court concludes in favour of the taxpayer.

The Court uncovers an interesting link between the principles of reciprocity and equality. Whereas under the principle of equality (as well as the principle of non-discrimination) the comparison is made between the treatment of State B nationals by State A and State A nationals by State A, under the principle of reciprocity, the comparison is made between the treatment of State B nationals in State A and State A nationals in State B. Applied to the present case: under the principle of non-discrimination, regard would be had to the question whether the treatment by the U.S. of U.K. beneficiaries was more burdensome than the treatment by the U.S. of U.S. beneficiaries. By contrast, under the reciprocity principle, the comparison is made between the treatment by the U.S. of U.K. beneficiaries and the treatment by the U.K. of U.S. beneficiaries.

b. Brown & Williamson Ltd[342]

In the years 1975 to 1978, a U.S. subsidiary distributed dividends to its U.K. parent company. In accordance with the 1945 U.K./U.S. treaty, which was applicable at the time of distribution, the U.S. subsidiary withheld U.S. taxes at a rate of 15%. The 1945 treaty was replaced by the 1975 treaty, which reduced the withholding rate to 5%. The 1975 treaty entered into force on 25 April 1980, but the provisions on source State withholding taxes were applicable retroactively to amounts paid or credited on or after 1 January 1975. Consequently, the U.K. parent sought and received a refund of the taxes paid on the distributed dividends. Furthermore, the parent company sought interest from the original date of payment of the refunded taxes. However, the U.S. tax authorities ruled that interest was due only from 25 April 1980, the date the treaty went into effect. The parent company appealed to the U.S. Court of Federal Claims, seeking interest for the period between 1975 and 25 April 1980.

Under the U.S. domestic rules on overpayments of taxes, interest on refunded taxes was paid from 'the date of the overpayment'. At issue in the case was the exact meaning of 'the date of the overpayment'. According to the taxpayer, the retroactive effect of the treaty provisions, making the reduction in taxes effective as of 1 January 1975, meant that the date of overpayment was the date upon which the refunded taxes were paid for the years 1975 to 1978. The U.S. tax authorities argued that, since the amount of taxes paid in those years was correct at the time of payment, there was no overpayment until the treaty on its effective date in 1980 reduced the taxes retroactively, and that that date therefore was the date of overpayment.

On the basis of the U.S. tax authorities' consistent practice and the language of the Internal Revenue Code, the Court agreed with the taxpayer, without referring to the issue of reciprocity. This issue was touched upon, however, in the dissenting opinion of Senior Judge Skelton. Referring to *American Trust Co.* (cf. supra), he argued that the decision should be made on the basis of reciprocity and equal tax treatment of the nationals of both countries (the U.K. and the U.S.). The applicable treaty was silent on the question of interest on tax

entire net income." At the time of the dispute, sixteen of twenty tax treaties negotiated by the U.S. contained a savings clause.

[342] U.S. Court of Federal Claims 8 August 1982, *Brown & Williamson Ltd. v. US*, 688 F2d 747.

returns[343], but under the laws of the U.K., no interest was paid on tax refunds. Therefore, like in *American Trust Co.*, there was no need for a provision on this point to be included in the treaty. As a result, if a U.S. national received a tax refund from the U.K., he could not collect interest on the refund. On the basis of reciprocity (and the precedent of *American Trust Co.*) a national of the U.K., such as the plaintiff *in casu*, who gets a tax refund from the U.S. should not be able to collect interest on the refunded taxes either: *"To hold otherwise places an economic burden on citizens of the United States as compared to citizens of the United Kingdom similarly situated. Obviously, the framers of the Treaty and the governments which ratified it did not intend to discriminate between the citizens of the two countries, nor to create a windfall for citizens of the United Kingdom, such as the plaintiff and others who may have similar claims, when such benefits are denied to citizens of the United States who are in a similar situation. Therefore, the plaintiff's claim should be denied on the basis of reciprocity."*

c. Dutch Supreme Court 2 September 1992[344]

This case is of particular interest since it deals specifically with reciprocity in the context of a treaty provision on nationality discrimination. A company was incorporated in the Netherlands, with the result that it was considered to be a resident of the Netherlands under Dutch domestic tax law. Since the real seat of the company was in Ireland, the company was a resident of Ireland for the purposes of the Dutch/Irish treaty[345]. The shares in the company were wholly held by a U.S. company. When the company paid out a dividend to its U.S. parent, the Dutch tax authorities levied tax on this dividend, limited to 5% in accordance with the Dutch/U.S. treaty.

Before the Supreme Court, the taxpayer relied on four arguments, one of which concerned non-discrimination. The Supreme Court ruled in favour of the taxpayer, unfortunately without touching upon the discrimination issue[346]. In contrast, the Advocate-General did consider the case against the background of non-discrimination.

The taxpayer relied on two non-discrimination provisions: Art. 1(1) TAK (see supra) and Art. XXV(4) of the Dutch/U.S. treaty[347]. The claim with regard to Art. 1(1) TAK was based on the argument that the U.S. parent company was being discriminated against because it was

[343] Similarly, in *American Trust Co.*, no provision was included in the treaty on the taxation of capital gains realized by trusts (cf. supra).
[344] Hoge Raad 9 February 1992, *BNB* 1992/379. The case concerned an appeal against Court of Appeal 's-Gravenhage 30 January 1990, no. 254/89-M-4.
[345] Art. 2(1)(f) of the 1969 treaty between Ireland and the Netherlands.
[346] The Supreme Court decided the issue on the basis of Art. 8(9) of the Dutch/Irish treaty (analogous to Art. 10(5) OECD MC). The Supreme Court held that the OECD Commentary states as a general principle that Art. 10(5) OECD MC prohibits extra-territorial taxation of dividends. As Art. 10(5) OECD MC prohibits such extra-territorial taxation in case the distributing company derives income from the State in question, the taxation is *a fortiori* prohibited in case the distributing company derives no such income. In the present case, the company was not taxed in the Netherlands because it derived income there, but because it was still deemed to be a Dutch resident for purposes of dividend taxation even though its real seat has been moved to Ireland. As the Supreme Court annulled on this basis, it did not take a position on the discrimination issue.
[347] *"A corporation of one of the Contracting States, the capital of which is wholly or partly owned by one or more citizens or corporations of the other Contracting State, shall not be subjected in the former Contracting State to more burdensome taxes than is a corporation of the former Contracting State, the capital of which is wholly owned by one or more citizens or corporations of that former Contracting State."* Thus, the provision prohibits discrimination against nationals of one contracting State owning the capital of corporations of the other contracting State. By contrast, Art. 24(5) OECD MC prohibits discrimination against residents of one contracting State owning the capital of or controlling enterprises of the other contracting State.

subject to more burdensome taxation than that to which it would be subject to if it were incorporated under Dutch law[348]. The claim with regard to Art. XXV(4) of the Dutch/U.S. treaty was based on the argument that the dividend taxation would not have been levied if the taxpayer had a parent company which was incorporated under Dutch law. Consequently, the taxation was more burdensome than it would have been if the capital of the taxpayer was held by a Dutch company. Both claims thus compare the U.S. parent company (U.S. national, U.S. resident) to a company incorporated in the Netherlands, which has moved its real seat to the U.S. (Dutch national, U.S. resident). If the dividend were paid to the hypothetical Dutch incorporated company, no withholding tax would be applied because the domestic participation exemption regime would be applicable[349].

The comparison is obfuscated by the issue addressed in 2.B.V.A: it could be argued that the U.S. parent company and the hypothetical Dutch incorporated company are not in the same circumstances, as the latter is liable to tax on its worldwide income by reason of its deemed Dutch residence, whereas the former is not so subject. The Advocate-General suggests that this problem may be side-stepped by holding that the difference in tax liability is directly connected with the difference in nationality. If a non-discrimination provision prohibits a distinction on the basis of nationality, then the prohibition also covers the fiscal characteristics which are inextricably connected with nationality (such as unlimited tax liability in the Netherlands, and the connected enjoyment of the participation exemption regime). In this reasoning, all foreign companies are protected by a nationality non-discrimination provision which precludes the Netherlands from withholding tax on dividends received by that company from a company subject to corporation tax in the Netherlands[350]: either the company can invoke a treaty provision analogous to Art. 24(1) OECD MC or, if no treaty containing such a provision applies, the company can still rely on Art. 1(1) TAK.

However, the Advocate-General does not accept this conclusion, because of the treaty policy which the Netherlands traditionally seeks to accomplish with regard to cross-border dividends. That policy has always been to reduce taxation on such dividends to nil, based on the idea that a dividend distribution within a multinational group of companies is very similar to a transfer of profits within an enterprise, which in general is not taxable. Furthermore, the substantial interests of Dutch entities with participations abroad form a justification for this course of action and an incentive for waiving, on a reciprocal basis, the right to tax such dividends by means of tax treaties. Yet, the Advocate-General perceives an international trend towards source State taxation of cross-border dividends. He therefore concludes that no discrimination occurs, as the Netherlands are only aligning themselves with an ongoing international evolution towards source State taxation of cross-border dividends. In support of this conclusion, the Advocate-General refers to the OECD Commentary on Art. 24(1), which indicates that the non-discrimination provision of Art. 24(1) is subject to reciprocity. This reference to reciprocity apparently leads the Advocate-General to the conclusion that there is no discrimination because most other States evolve towards source State taxation of cross-

[348] As indicated above, Art. 1(1) TAK is very similar to Art. 24(1) OECD MC. The differences between both (e.g. the wider personal scope) do not affect the present issue. As a result, the taxpayer might equally have invoked (a provision analogous to) Art. 24(1). Furthermore, the Advocate-General repeatedly refers to Art. 24(1) in making his analysis. The Advocate-General's analysis of the reciprocity principle is thus relevant in the context of Art. 24(1) OECD MC as well.

[349] Provided that the relevant conditions are met (see Art. 4(2) of the Law on dividend taxation 1965).

[350] On the condition, of course, that the foreign company is in the same circumstances as a company incorporated in the Netherlands enjoying the benefit of the participation exemption regime, i.e. the foreign company must have a participation of at least 5% in the Dutch company.

border dividends, which would discharge the Netherlands from its non-discrimination obligation[351].

This is quite a broad interpretation of reciprocity. First of all, no reference is made to the actions of the treaty partner: source State taxation of dividends in contravention of the tax treaty is apparently possible 'because everybody else does it', without referring to what the treaty partner (the U.S.) does. This goes beyond the traditional concept of reciprocity, in which an action may be justified because it is a reaction to what the other treaty partner has done. The Advocate-General seems to suggest that an 'international trend' towards a certain course of action might justify a departure from a rule laid down in a tax treaty, because of the principle of reciprocity: as most other States levy withholding taxes on dividends, the Netherlands should be able to do the same. Such an interpretation is, in my opinion, too extensive. Reciprocity is inseparable from the relational framework created by the treaty: the bilateral nature of the treaty demands that the mechanism of reciprocity is sparked off by the actions of the other treaty partner. References to general international trends or evolutions of the international community as a whole have no place in the bilateral relational framework between two treaty partners. Furthermore, the Advocate-General is of the opinion that the principle of reciprocity allows States to deviate from material obligations flowing from the tax treaty. The case law addressed above refuses to attach such far-reaching consequences to the reciprocity principle. As I will argue below, the principle of reciprocity should probably not be read as a blanket justification for non-observance of the treaty provisions, but rather as a principle imposing positive obligations, mainly with respect to procedural guarantees.

d. Dutch Supreme Court 20 November 2009[352]

This is another case dealing with reciprocity in the context of nationality discrimination. The taxpayer was a resident national of Italy who owned a second dwelling in the Netherlands. Pursuant to the Dutch tax rules on investment income, he was subject to tax in the Netherlands on that dwelling. Before the Dutch Supreme Court, the taxpayer invoked the nationality non-discrimination provision of the Dutch/Italian treaty[353]. In particular, he argued that the taxation in the Netherlands was incompatible with the principle of reciprocity because a national of the Netherlands owning a second dwelling in Italy would owe eight times less Italian tax.

The Supreme Court dismissed the taxpayer's claim because there was no nationality discrimination. In particular, a national of the Netherlands in the same circumstances as the taxpayer – i.e. being a resident of Italy and having a second dwelling in the Netherlands – would be subject to the same tax treatment in the Netherlands. As to the principle of reciprocity, the Court pointed out that the non-discrimination provision of the treaty only

[351] The Advocate-General also referred to another reason why no discrimination would occur: Art. XIX(2) of the Dutch/U.S. treaty grants a tax credit for the dividend tax paid in the Netherlands (*"The United States shall allow to a citizen, resident or corporation of the United States as a credit against its tax specified in subparagraph 1(a) of Article I the appropriate amount of taxes paid to the Netherlands. Such appropriate amount shall be based upon the amount of tax paid to the Netherlands on income from sources within the Netherlands but shall not exceed that proportion of the United States tax which taxable income from sources within the Netherlands bears to the entire taxable income"*). According to the Advocate-General, this implies that the taxation is not always more burdensome. As argued above, however, only the treatment in the taxing State is relevant when assessing whether discrimination exists. Counterbalancing measures in the home State have no role to play in this determination.
[352] Hoge Raad 20 November 2009, No. 08/01919, *BNB* 2010/39 c.
[353] Art. 25(1) of the 1990 treaty, which is identical to Art. 24(1) 1977 OECD MC.

targeted (certain) differences in treatment in the levying of tax by one contracting State. Neither the principle of reciprocity, nor any other rule of law implied that the Netherlands and Italy were required to apply the same tax rates to second dwellings[354].

So the Court clearly distinguishes the principle of discrimination from the taxpayer's broad interpretation of reciprocity. Reciprocal taxation would mean that an Italian national would be subject to the same tax treatment in the Netherlands as a Dutch national in Italy. But that is not how non-discrimination works. As the Court correctly decides, the nationality non-discrimination provision only implies that the Netherlands cannot treat Italian nationals less favourably than Dutch nationals. It does not imply a positive obligation for both contracting States to coordinate their tax systems[355].

VII.C. Conclusion

Defined in a broad manner, as the expectation of a State that the treaty partner will fulfill its treaty obligations and the connected motivation of that State to do the same, the principle of reciprocity underlies most treaties[356]. In tax matters, the consequences to be given to non-adherence by the other contracting State, however, are not entirely clear-cut. The only possible consequence seems to be the non-performance of the treaty[357] (non-performance by State A leads to non-performance by State B), but the scope of such non-performance is unclear.

First of all, with regard to the first non-performance (the non-performance by State A): the type of reciprocity to which the OECD Commentary on Art. 24(1) refers is *formal reciprocity*. This means that the State concerned is only required to treat the nationals of the other State no more burdensome than its own nationals; the contents of the treatment are not at issue[358]. As long as the treatment is no more burdensome, the test is passed; regardless of the quality of the treatment. In other words, the requirement is relative, and not absolute: the treatment

[354] The original text of the decision reads as follows: *"Artikel 25, lid 1, van het Verdrag ziet slechts op (bepaalde) verschillen in behandeling bij de belastingheffing door eenzelfde verdragsluitende Staat. Noch de verwijzing in deze bepaling naar het wederkerigheidsbeginsel, noch enige andere rechtsregel brengt mede dat Nederland en Italië over en weer gelijke belastingtarieven zouden moeten hanteren voor tweede woningen op hun grondgebied."*

[355] The Italian Commissione Tributaria Centrale (Central Tax Court) has taken the opposite position in a decision of 10 September 1998 (No. 4318, *Royal Air Maroc*, IBFD Tax Treaty Case Law Database). A Moroccan company failed to comply with reporting obligations in Italy with respect to Italian-sourced income. For that reason, the Italian tax authorities imposed a penalty. The taxpayer argued that the nationality non-discrimination clause of the 1972 Italian/Moroccan tax treaty (identical to Art. 24(1) of the 1963 Draft Convention) precluded Italy from imposing requirements on Moroccan nationals that were not imposed on Italian nationals in Morocco. Since, under the Moroccan tax system, Italian taxpayers would not have to file a tax return with respect to Moroccan-sourced income, the same should be true for Moroccan taxpayers earning Italian-sourced income. The Central Tax Court decided in favour of the taxpayer and held that the nationality non-discrimination clause implied that Italy could not impose Moroccan taxpayers to more burdensome treatment than that imposed in Morocco to an Italian taxpayer in the same circumstances. This decision has rightly been criticized in legal literature (e.g. M. TENORE, "Italy", in *Cahiers de droit fiscal international. Non-discrimination at the crossroads of international taxation*, Vol. 93a, Amersfoort, Sdu Fiscale & Financiële Uitgevers, 2008, 350).

[356] Cf. B. SIMMA, *o.c.*, 400-401: *"From a purely formal point of view, reciprocity governs every international agreement, independently of its content, and consequently underlies the rules concerning the conclusion and entry into force of treaties, and their application, termination, amendment and modification."*

[357] Traditional sanctions such as retorsions and reprisals are indeed better suited for areas of law in which the concept of reciprocity has more prominently developed, e.g. the law of armed conflicts.

[358] A. LENHOFF, "Reciprocity: the legal aspect of a perennial idea", *Nw. U. L. Rev.* 1954-55, 770.

required is the treatment which is accorded to the nationals of the State concerned; the contents of that treatment are not specified[359].

If a State does treat foreigners less favourably than its own nationals, and thus violates its obligations under a formal concept of reciprocity, this non-performance impacts the other State's obligations under the non-discrimination provision. However, the extent to which a State can invoke a breach of the non-discrimination provision by the other State to justify discriminatory treatment against the nationals of that other State is open to debate. Can a discriminating State justify its actions by merely establishing that the other State discriminates as well, or must both discriminations be of the same type? Should both discriminations relate to the same group of taxpayers? Should the second discrimination be proportionate to the first? If the obligations under the reciprocity principle are construed too broadly, the non-discrimination provision might be eroded, as no taxpayer would be succesful in challenging a discriminatory taxation in his host State as long his home State has not eliminated all forms of discrimination against nationals of the host State.

Therefore, a more restrictive interpretation may be appropriate, in which the concept of reciprocity in the context of nationality discrimination does not require State A, as a *quid pro quo*, to have ceased its discrimination against State B nationals, but merely requires that State A likewise opens its courts to suits by State B nationals on grounds of discrimination. That way, discrimination on both sides could be allieviated concurrently. In this interpretation, the principle of reciprocity would only be violated if one contracting State were unresponsive to legitimate discrimination claims made by nationals of the other contracting State[360]. Thus, the principle of reciprocity should not serve as a justifiation for States to rid themselves of their obligations under the non-discrimination provision. Rather, it imposes positive obligations, mainly with respect to procedural guarantees. Reciprocity is duly guaranteed if taxpayers of one State have the possibility to effectively challenge seemingly discriminatory tax treatments by another State before the courts of the latter State.

As an example, I refer to the position in certain dualist States (such as the U.K.) that there needs to be a 'relevant incorporation' of tax treaty provisions. In the *Boake Allen* case[361], the question arose whether there was a remedy in U.K. law for the taxpayer to enforce the treaty non-discrimination provision with regard to the advanced corporation tax (ACT)[362]. Between 1973 and 1999, a company resident in the U.K. which paid a dividend was liable to pay ACT. This payment could be set off against its liability for corporation tax on its profits ('mainstream corporation tax' or MCT). Additionally, the recipient of the dividend was entitled to a tax credit for the ACT. If the recipient was a company, the income received (i.e. the dividend and the tax credit) was exempt and could be distributed to the recipient's own shareholders without further payment of ACT.

---

[359] By contrast, *material reciprocity* refers to an absolute standard, i.e. the treatment the foreigner receives in his home State. Take for example a State A national who feels he is being discriminated against in State B. Material reciprocity would require State B to accord to the State A national the treatment he would receive in State A. Application of material reciprocity is exceptional and might lead to complex issues, as it might require the protection of rights which do not exist in the State concerned.

[360] J. O'BRIEN, *o.c.*, 610.

[361] House of Lords 23 May 2007, *Boake Allen Ltd. v. Revenue and Customs Commissioners*, 1 *W.L.R.* 2007, 1386, discussed in 2.F.II.D.d. A similar issue arose in the *UBS* case with regard to the permanent establishment non-discrimination provision; see infra, 2.D.III.C.c.1.

[362] For an extensive discussion of this issue, see R. KALUNGI, "Confusion worse confounded: what Boake Allen teaches us about the (non-)incorporation and interpretation of double taxation treaties in the United Kingdom", *B.T.R.* 2009, 129-154.

Section 247 of the Income and Corporation Taxes Act 1988 (ICTA 1988) provided that a parent and subsidiary, both resident in the U.K., could jointly elect that the subsidiary would pay dividends free of ACT and that the parent would receive them without the benefit of a tax credit. The dividends would not be exempt in the hands of the parent and the parent would be liable for ACT when it passed them on as dividends to its own shareholders. The advantage to the group was that money could be moved from subsidiary to parent without attracting an immediate liability to ACT.

At issue in the *Boake Allen* case was whether the denial of such a right of election if the parent was not a U.K. resident violated the tax treaty non-discrimination provision[363]. As pointed out above, an international treaty such as a tax treaty does not give rise to any rights in English domestic law unless incorporated by legislation[364]. Section 788 of the ICTA 1988 provides that *"Her Majesty [may] by Order in Council declare that arrangements [made by tax treaties] shall have effect"*. However, the effect is not to make the entire tax treaty part of English law. Rather, Section 788(3) specifies that the arrangements have effect *"in relation to income tax and corporation tax in so far as they provide for relief from income tax, or from corporation tax in respect of income or chargeable gains"*.

In first instance as well as in appeal, it was held that Section 788 did not give effect in U.K. domestic law to any arrangement which a tax treaty might make about liability to ACT[365]. According to both courts, 'corporation tax in respect of income or chargeable gains' in section 788(3) meant MCT, not ACT. The infringement of the tax treaty non-discrimination provision therefore gave rise to no cause of action in U.K. law.

As a result, a non-U.K. resident taxpayer is unable to enforce the treaty right, even where a U.K. resident taxpayer in the same circumstances facing discriminatory taxation by another State in breach of a tax treaty non-discrimination provision could enforce his treaty rights in that other State. Such a discrepancy obviously upsets the reciprocity principle, interpreted as a guarantee for taxpayers to effectively challenge seemingly discriminatory tax treatments by another State before the courts of that State.

The Advocate-General's interpretation of reciprocity in the 1992 case before the Dutch Supreme Court is probably too broad. The mere existence of an international trend towards taxation of a certain element of income cannot justify a State's non-observance of an express treaty prohibition to tax such an element of income. Moreover, even if, hypothetically, the Advocate-General had determined that, in the reciprocal situation, the other contracting State (the U.S.) would tax the dividends, the Netherlands should not violate express treaty prohibitions by mere reference to reciprocity. The conclusions reached in *American Trust Co.* and *Brown & Williamson Ltd.* seem at first sight comparable to the Advocate-General's opinion, but they are somewhat less far-reaching. In both cases, the treaty was silent on the situation at issue: in *American Trust Co.*, the treaty did not address capital gains realized by trusts, while in *Brown & Williamson Ltd.*, the treaty did not address interest on refunds. In both cases, the Court (and Senior Judge Skelton in *Brown & Williamson*) relied on the

---

[363] See also infra, Part III, I.A.b.5.a on Joined Cases C-397/98 and 410/98, *Metallgesellschaft*, in which the ECJ decided that such a denial amounted to a restriction on the freedom of establishment.
[364] For instance, the EC Treaty was incorporated, in its entirety, by the European Communities Act 1972.
[365] Court of Appeal 31 January 2006, 8 *ITLR* 819; High Court, Chancery Division 24 November 2003, 6 *ITLR* 416. The appeal was dismissed by the House of Lords as well, but in doing so, more attention was paid to the application of Art. 24(5) of the treaty; see infra, 2.F.II.D.d.

concept of reciprocity to address these lacunae. Thus, in both of these cases, the principle of reciprocity was applied *praeter legem*, to fill in the blanks left by the treaty, whereas the Advocate-General in the 1992 Dutch case applied the principle of reciprocity *contra legem*, allowing the Netherlands to evade their treaty obligations. The interpretation *praeter legem* can be approved of. A treaty should be interpreted in the light of its object and purpose (Art. 31 VC). It has been argued above that reciprocity underlies most, if not all, tax treaties. When States waive taxing rights in a tax treaty, they do this because they trust the other State will do the same in the reciprocal situation. Consequently, if the treaty is silent on a certain issue, the principle of reciprocity should play a role in interpreting the treaty[366].

Finally, it is strange that only the first paragraph of the non-discrimination Article should be subject to reciprocity, while this would not be required for the other paragraphs. However, the omission of an express reference to the principle of reciprocity in the Commentary to the other non-discrimination provisions does not necessarily mean that they are not subject to reciprocity. As noted above, the concept of reciprocity can be considered to underly most treaties[367]. As a result, the reasoning set out above applies to the other non-discrimination provisions as well.

AVERY JONES points out that the reference to 'reciprocity' in the Commentary might be an error. It is possible that, instead, it should have said that the provision requires 'reciprocal taxation treatment of nationals' as was stated in the 1958 Report of the OEEC Fiscal Committee[368] (see supra, 2.1.C). It is not entirely clear, however, what the difference is between subjecting a nationality non-discrimination clause to reciprocity and requiring taxation treatment of nationals to be reciprocal. In any event, 'reciprocal taxation' should not be interpreted as requiring both contracting States to ensure that their respective nationals bear an equally heavy (or light) tax burden[369].

---

366 See U.S. Supreme Court 3 February 1890, *De Geofroy et al. v. Riggs et al.* 133 U.S. 258: *"It is a general principle of construction with respect to treaties that they shall be liberally construed, so as to carry out the apparent intention of the parties to secure equality and reciprocity between them."*; U.S. Supreme Court 19 November 1928, *Jordan v. Tashiro* 278 U.S. 123, 127: *"The principles which should control the diplomatic relations of nations, and the good faith of treaties as well, require that their obligations should be liberally construed so as to effect the apparent intention of the parties to secure equality and reciprocity between them. Upon like ground, where a treaty fairly admits of two constructions, one restricting the rights that may be claimed under it and the other enlarging them, the more liberal construction is to be preferred."*

367 Cf. also A. LENHOFF, *o.c.*, 768: *"Treaties must be deemed to be reciprocal, in absence of a contrary provision, because reciprocity is inherent in the nature of treaties; non-reciprocal treaties are treated as exceptions."* See also case law, e.g. U.S. Court of Appeals for the Ninth Circuit 8 July 1957, *American Trust Company,* 247 F.2d 149: *"We conceive the purpose of the Treaty to have been full reciprocity and equality of tax treatment between nationals of the United States and the United Kingdom. […] This is also true as to the Income Tax Convention, its purpose being to secure reciprocity and equality of tax treatment between the nationals of the two contracting parties. […] A study of the Articles of the Convention indicates an attempt to achieve a thoroughgoing reciprocity between the two nations' taxpayers in similar situations"*; Indian Income Tax Appellate Tribunal 30 December 2004, *Wipro Ltd.* Nos. 152 to 154/Bang/2004: *"Further, in the era of globalization when nation after nation are embracing each other in economic collaborations or co-operation, non-discriminatory treatment to one and all is the underlying principle. It would be incorrect to argue a case on a misplaced feeling that foreigners are getting away without paying any tax in India. We find that the DTAA offers fair chance to Indian business houses outside India and similar treatment should also be extended in India. That is the basis of principle of reciprocity, one of the basic principles entering into agreement for avoidance of double taxation."*

368 First Report of the Fiscal Committee of the OEEC on the elimination of double taxation, September 1958, *Legislative History of United States Tax Conventions,* vol. 4, 1962, 4465.

369 K. VOGEL, *o.c.*, 1297.

Another possible explanation is that the reciprocity requirement aims at preventing a third state national from claiming the benefits under an MFN-clause[370] (i.e. that the protection offered by the non-discrimination provision only has effect in the bilateral relation between the States parties to the treaty; see supra). This, however, does not detract from the conclusion reached above, i.e. that the principle of reciprocity underlies all treaties, unless the treaty says otherwise. Furthermore, the importance of the reciprocity principle should not be restricted to merely confirm the absence of an implicit MFN-clause in the non-discrimination provision: reciprocity imposes positive obligations, by demanding that taxpayers of one State have the possibility to effectively challenge seemingly discriminatory tax treatments by another State before the courts of the latter State.

That being said, it is clear that reciprocity, whatever its appropriate interpretation is, will often be an ideal which the practical application of a tax treaty will not live up to. While tax treaties, and the non-discrimination provisions included in those treaties, aspire to reciprocity, the issues discussed above (and in particular the U.K. practice on the incorporation of tax treaties) illustrate that this ideal will often remain unrealized[371].

Finally, it should be noted that the concept of reciprocity will also be addressed in Part III, I.A.b.9, where the interaction between tax treaties and European tax law will be discussed.

VIII. Comparability as a safety valve?

Art. 24(1) does not offer the possibility to justify discriminatory taxation. If the relevant circumstances are the same, other or more burdensome taxation will not be allowed, regardless of the goals pursued by the discriminatory measure. There are indications, however, that this rigid pattern is mitigated in practice. As mentioned earlier, the traditional decision-tree of a discrimination-test consists of three steps: the question whether two situations are comparable, the question whether those situations are treated differently, and finally the question whether the different treatment is justified. For instance, in the decision tree used by the ECJ (see Part III), it is possible to uphold a situation which is, strictly speaking, discriminatory, but which is justified by the presence of certain overriding interests. By contrast, the decision tree under Art. 24 does not contain such a safety valve. As the decision-tree under Art. 24(1) does not have the third step, there may be a tendency in certain cases to interpret the first and second step liberally, in order to avoid reaching the conclusion that the measure at issue is discriminatory.

The most obvious let-out is denying the comparability of the circumstances. For instance, a U.S. private letter ruling concerned the entitlement of a Dutch pension fund to the non-discrimination provision of the applicable Dutch/U.S. treaty[372]. In case the Dutch fund could

---

[370] J. AVERY JONES, *et al.*, “The non-discrimination article in tax treaties”, *European Taxation* 2001, 312, referring to a 1931 Report of the League of Nations Fiscal Committee, *Legislative History of U.S. Tax Conventions*, vol. 4, 1962, 4237.

[371] As the U.K. High Court of Justice observed in *Commerzbank AG and Banco do Brasil SA*, which concerned the effect of the principle of reciprocity on a contracting State’s obligations under the treaty provisions on withholding taxes on interest and dividends: *“reciprocity is an ideal to which the convention aspires but may fail to achieve in all cases”* (High Court of Justice (Chancery Division) 9 February 1990, *CIR v. Commerzbank AG; CIR v. Banco do Brasil SA*, (1990) S.T.C. 285).

[372] TAM 8030005 of 28 March 1980, *WL* 1980, 139176 (IRS TAM). At issue was the PE non-discrimination provision, but the comparability test was interpreted by relying on treaty practice and the Commentary on the nationality non-discrimination provision.

invoke the non-discrimination clause, then it would be entitled to a tax exemption granted under U.S. domestic tax law. The IRS decided, however, that the Dutch fund was not entitled to the non-discrimination clause because it was not in the same circumstances as a U.S. fund. The purpose behind the exemption in question was to *"encourage the development and use of private pension funds by United States employers so that their employees would not have to rely on public welfare after retirement for their support in their old age."* This was considered to be a 'public purpose' by the IRS. As the pensions paid by the Dutch fund were primarily payable to employees other than U.S. nationals or residents, *"the social purposes served by domestic pension plans (to benefit American workers) would not apply to a foreign pension fund benefitting primarily foreign workers."* Thus, the 'public purpose' served by the American pension funds rendered them incomparable to foreign pension funds.

It should be borne in mind, however, that there is a very fine line between, on the one hand, taking into account the relevance of a certain factor for the tax measure at issue when determining the comparability, and, on the other hand, using relevance in order to justify a discriminatory measure. The former is inherent in the non-discrimination test of Art. 24 OECD MC and therefore not objectionable. The latter, however, finds no support in the text of the OECD MC, nor in the Commentary.

In the U.S. private letter ruling discussed above, reference is made to the Comm. OECD which contains the following relevant clarification in this regard:

> *the provisions of paragraph 1 are not to be construed as obliging a State which accords special taxation privileges to its own public bodies or services as such, to extend the same privileges to the public bodies and services of the other State. […] Neither are they to be construed as obliging a State which accords special taxation privileges to private institutions not for profit whose activities are performed for purposes of public benefit, which are specific to that State, to extend the same privileges to similar institutions whose activities are not for its benefit.*
>
> *To take the first of these two cases, if a State accords immunity from taxation to its own public bodies and services, this is justified because such bodies and services are integral parts of the State and at no time can their circumstances be comparable to those of the public bodies and services of the other State. Nevertheless, this reservation is not intended to apply to State corporations carrying on gainful undertakings. To the extent that these can be regarded as being on the same footing as private business undertakings, the provisions of paragraph 1 will apply to them.*
>
> *As for the second case, if a State accords taxation privileges to certain private institutions not for profit, this is clearly justified by the very nature of these institutions' activities and by the benefit which that State and its nationals will derive from those activities*[373].

Thus, the Comm. OECD seems to address the exact situation at issue in the U.S. private letter ruling. Nevertheless, some remarks are in order. First of all, the Comm. OECD seems to confuse two important steps in the traditional decision tree of a discrimination analysis. The

[373] Comm. OECD on Art. 24, paras. 10-13.

first step in the decision tree is the question as to the comparability of the relevant situations. In case the situations are comparable, the second step is the conclusion that non-discriminatory treatment is necessary. The third and final step is the question as to whether a situation which is found to be discriminatory in the second step, may persist because it is justified on the basis of certain overriding grounds. The Comm. OECD states that *"if a State accords immunity from taxation to its own public bodies and services, **this is justified** because such bodies and services are integral parts of the State and at no time can their circumstances be comparable to those of the public bodies and services of the other State"* and *"if a State accords taxation privileges to certain private institutions not for profit**, this is clearly justified** by the very nature of these institutions' activities and by the benefit which that State and its nationals will derive from those activities"*.

This reasoning is flawed, as there is no need for justification when the relevant situations are not comparable. If and only if the situations are comparable, can a different treatment amount to discrimination, which may be justified. In the absence of comparability, no discrimination arises, which means that there is nothing to justify. The mere assessment that the situations are not comparable suffices to deny the existence of discrimination. Furthermore, the possibility of justifying a discriminatory treatment does not exist under Art. 24 OECD MC. Unlike the ECJ's decision tree, there are no overriding grounds of public interest which may be invoked in order to justify a measure which violates Art. 24. If the situations are comparable, non-discriminatory treatment is mandatory. Therefore, the decision tree under Art. 24 OECD MC consists of only two steps.

On the other hand, one may interpret the use of the word 'justified' in the Comm. OECD to mean precisely that the incomparability of the situations excludes any possibility of discrimination, which implies that any difference in treatment is 'justified' beforehand. However, the Comm. OECD seems to go beyond such an interpretation, by stating that according tax privileges in such cases is *"justified **because such bodies and services are integral part of the State**"* and *"justified **by the very nature of these institutions' activities and by the benefit which that State and its nationals will derive from those activities**"*. This argument is, at the very least, confusing, if not incorrect. Not the nature of the activities in question, nor the fact that the bodies and services are part of the State is the direct reason why there is no discrimination. Rather, the incomparability of the situations renders any discrimination impossible. The incomparability may indeed be caused by certain tax-relevant factors, such as the nature of the activities at issue, but the relevance of these factors must always be determined *in concreto*, by holding them up against the light of the allegedly discriminatory tax measure.

Consequently, it may be somewhat impetuous to declare any tax privilege accorded to public bodies and services to be non-discriminatory by reason of their nature. Only where the public purpose is relevant for the tax at issue will any possibility of discrimination be excluded by reason of the incomparability of the situations. Furthermore, even in those cases will 'the nature' of the public bodies and services only indirectly explain the absence of any form of discrimination: the direct reason is the incomparability (which, in turn, is caused by the relevant distinguishing factor, i.e. the 'public purpose')[374].

[374] There is an additional point to be addressed here. The Commentary seems to suggest (as it does with respect to Art. 24(3) in Comm. OECD on Art. 24, para. 47; see 2.D.III.B.a) that a foreign non-profit organisation is incomparable to a national non-profit organisation because the former does not carry out activities that are exclusively to the benefit of the source State. But there is no reason why those situations can only be comparable if the activities are carried out to the **exclusive** benefit of one State. Why would a foreign charity be

In conclusion, the decision tree under Art. 24(1) OECD MC is very straightforward. The first step consists of determining the comparability of the situations at issue. If the situations are comparable, the second and final step is the conclusion that they must be treated in a non-discriminatory manner. As indicated earlier, a possible (but questionable) let-out is the comparability test, which consists of assessing whether the characteristics that are shared among the situations at issue (or the characteristics that are different among them) are relevant for the tax measure under scrutiny.

The 2008 update to the Comm. OECD emphasizes the importance of the relevance of these characteristics in the new paragraph 9: it is stated there that it may be necessary to take into account a person's tax situation when applying the comparability test. This will only be the case, however, when scrutinizing those measures of the domestic tax law *"with respect to which the comprehensive or limited liability to tax of a taxpayer **would be relevant** (e.g. the granting of personal allowances)"* (emphasis added). Similarly, the new para. 18 of Comm. OECD on Art. 24 indicates first that residents and non-residents are usually not in the same circumstances for the purposes of Art. 24(1), but adds that this is not the case *"where residence has no relevance whatsoever with respect to the different treatment under consideration"*[375].

Thus, by interpreting the relevance requirement (i.e. the requirement that the characteristics shared by - or different among - the situations at issue are relevant for the tax measure under scrutiny) in a broad manner, one may incorporate something closely akin to a safety valve in Art. 24 OECD MC. However, case law has been quite restrictive in interpreting the relevance requirement. For instance, the New York Supreme Court for New York County in the *Lufthansa* case (see supra, 2.B.V.A) held that the government ownership of a stock was not a relevant consideration in determining the comparability of the situations at issue[376]. Similarly, the Tribunal Administratif de Nice has rejected the position of the French tax authorities that foreigners resident abroad cannot be compared with French nationals resident abroad as French nationals have closer personal and economic ties to France and are more likely to return to France. The 'closer personal and economic ties' of the object of comparison do not render both groups incomparable, as that particular difference is irrelevant to the comparison (see supra, 2.B.V.A).

---

incomparable to a national charity if it carries out activities to the benefit of its home State **and** to the benefit of the source State? Compare this to the ECJ's position, discussed in Part III, 2.E.I.A.b.10. Consider also the following proposal in Comm. OECD on Art. 18, para. 69: *"Where, under their domestic law, two States follow the same approach of generally exempting from tax the investment income of pension funds established in their territory, these States, in order to achieve greater neutrality with respect to the location of capital, may want to extend that exemption to the investment income that a pension fund established in one State derives from the other State. In order to do so, States sometimes include in their conventions a provision drafted along the following lines: 'Notwithstanding any provision of this Convention, income arising in a Contracting State that is derived by a resident of the other Contracting State that was constituted and is operated exclusively to administer or provide pension benefits and has been accepted by the competent authority of the first-mentioned State as generally corresponding to a pension scheme recognised as such for tax purposes by that State, shall be exempt from tax in that State.'"*

[375] See also Comm. OECD on Art. 24, para. 7, as amended in 2008: *"The expression 'in particular with respect to residence' makes clear that the residence of the taxpayer is one of the factors **that are relevant** in determining whether taxpayers are placed in similar circumstances"* (emphasis added).

[376] At the same time, the Court held that *"ownership of the shares of stock of a foreign corporation is **not a reasonable basis** upon which to distinguish 'like situations' for tax purposes."* It is not entirely clear what is meant by "a reasonable basis." The requirement that a factor is relevant for tax purposes is not the same as the requirement that the factor is "a reasonable basis" upon which to distinguish. The former is a mere factual test, whereas the latter requires a certain amount of discretion thereby allowing for a more liberal interpretation.

It should also be borne in mind that the relevance requirement is a factual (objective) test, which leaves little room for discretion, whereas justification requires an appraisal to be made, a comparative (and subjective) assessment between different conflicting interests (*in casu* between the desire to abolish nationality discrimination and the public interest invoked by the discriminating State). As indicated earlier, the justification of a discriminatory measure takes place in the third step of the decision tree. As there is no such third step in the decision tree under Art. 24 OECD MC, it would be artificial to incorporate it in the first step, i.e. in the comparability test. In order to allow for a more liberal interpretation (regardless of whether this is desirable), the OECD MC would have to expressly confirm that certain purposes act as an overriding ground of public interest, thereby justifying exisiting discriminatory measures.

> A brief note on the desirability of justification grounds under Art. 24 OECD MC. On the one hand, one could argue that the OECD MC has no need for grounds of justification. As the scope and purpose of the non-discrimination provision of the OECD MC is much more restricted than the scope of the European fundamental freedoms, there is no need to attenuate the decision tree. On the other hand, one could say that the current provision in the OECD MC is too rigid, and leaves no room for flexibility.
>
> Even if it can be said that Article 24 is too inflexible for modern international tax practice, I do not think that it would be advisable to incorporate more justification grounds in Article 24, for instance on the basis of a rule of reason test such as that developed by the ECJ. Justification is a matter of policy, while the discrimination-test should be strictly neutral and free from interference from policy-objectives. For instance, in the ECJ's case law on direct taxation, the acceptance of justification grounds is determined by the equilibrium between Member States' tax sovereignty and the realization of the internal market (which is, in essence, a policy choice to be made by the competent legislator or, alternatively, by a central judicial body that balances these interests). Considerations of this nature should not affect the discrimination-test, which should instead be a mechanical analysis into comparability and equal treatment. This point will be addressed in more detail in Part IV, 1.B.

For another example of this issue, see the *Automated Securities Clearance*-case, discussed in 2.D.III.C.a.3.

IX. Other or more burdensome as a safety valve?

As indicated earlier, the decision tree under Art. 24(1) OECD MC consist of only two steps: first, the comparability of the situations at issue is determined. If the situations are comparable, the second and final step is the conclusion that they must be treated in a non-discriminatory manner. As argued above, the first step should not be interpreted in a manner which allows it to function as a safety valve. A decision of the Argentine National Supreme Court of Justice seems to take another approach, instead using the second step as a safety valve. More specifically, the comparability of the situations was not denied, but instead the existence of discriminatory treatment was denied by interpreting the expression 'other or more burdensome' in a very creative manner.

Hoechst AG, a company resident in Germany, owned shares in two affiliated companies resident in Argentina. The two Argentine companies were liable to pay net worth tax ("*impuesto al patrimonio neto*") of 2% on the value of the shares as substitute taxpayers for Hoechst AG. Had the shares been owned by a company incorporated and resident in

Argentina, then the company would have been subject to a different tax, the tax on capital ("*impuesto a los capitales*"), at a lower rate of 1.5%. Hoechst AG complained that the net worth tax violated the nationality non-discrimination provision of the treaty between Germany and Argentina, which was identical to Art. 24(1) OECD MC. The trial court decided in favour of Hoechst AG, but the decision was overturned by the appellate court. Hoechst AG appealed to the National Supreme Court of Justice[377].

The Supreme Court first considered that the Argentine law distinguishes between the situation where an individual residing in Argentina holds shares in an Argentine company, and the situation where such shares are held by an individual residing abroad. In the latter case, a different method of tax collection applies: a so-called 'substitute taxpayer' will be liable to the tax. Furthermore, the domestic provisions create an irrebuttable presumption that non-resident companies are owned by non-resident shareholders. Consequently, if a non-resident company holds shares in an Argentine company, the 'substitute taxpayer'-regime automatically applies. In the case of Hoechst AG, the two Argentine affiliates were the substitute taxpayers.

The Court indicates that a comparison between the 2% tax rate applicable to companies domiciled abroad and the 1.5% tax rate for companies resident in Argentina, *"leads to the prima facie conclusion that the situation of foreign companies is more burdensome than that of Argentine companies."* However, the Court immediately refutes this, by holding that *"the regulations under consideration must be interpreted harmoniously, in the light of the aim pursued by the legislature to obtain a proper result. On such basis and in view of the specific characteristics of tax matters, where fictions are an important means to achieve radical repercussions for fiscal administrations beyond their own boundaries […], a comparison may be drawn between taxpayers under similar circumstances."*

By considering the overall tax burden, the Court concludes that the treatment is not discriminatory:

> *"In fact, upon examining the situation of the company domiciled abroad, it may be concluded that the treatment received by it was not different from that of an Argentine company, since – by virtue of the advance payments permitted under s. 14, par. 3 of the Net Worth Tax Law – foreign companies only paid a 0.5% difference. The reason for this was that the legislature reasonably presumed that behind legal entities there were always natural persons who owned the property and were the ultimate taxpayers. This means that the system was based on a legal fiction relying on the need to identify who was the actual owner of the property, thus preventing the disappearance of the tax obligation by reason of the fact that the owner was a legal person settled abroad.*
>
> *There was no difference in tax treatment received by the taxpayer domiciled in Argentina […] who owned shares in the capital stock of a corporation established under Argentine law, since by reason of the amount involved here he would have been subject to a 2% maximum marginal rate and to personal taxation at a 0.5% rate. This is so since the aforementioned regulation provided that the cap for the computation of advance payments of the net worth tax was limited to the extent by which the tax obligation was increased*

[377] National Supreme Court of Justice 28 April 1998, *Hoechst AG v DGI*, 3 *ITLR* 1.

> *by the incorporation of such shares into the net worth. Such credit could not exceed the amount resulting from applying the prevailing rate of the tax on capital. In addition, such taxpayer was, in turn, covered by a presumption of law which provided for a minimum amount to be reported in respect of personal and household assets."*

The Court's reasoning is somewhat muddled, but the conclusion seems to be that there is no discrimination because the 0.5% difference was merely intended to place shareholders of non-resident companies (who are presumed to be non-residents of Argentina) in the same overall tax position as Argentine residents: *"No discriminatory purpose is being pursued, but rather the need to actually collect from the foreign owner the tax levied on his net worth in Argentina, in the same way as the net worth tax applies to natural persons domiciled in Argentina owning shares in the capital stock of entities resident in Argentina."* In other words, the 0.5% difference is taxable in the hands of the substitute taxpayer in order to ensure that a proper amount of tax has been paid. By contrast, in the case of an individual shareholder resident in Argentina, such an approach would not be necessary since the proper amount would be taxable in his hands, in the individual income tax.

This interpretation is questionable. The legitimate purpose of the measure under scrutiny and the fact that *"no discriminatory purpose is being pursued"* is irrelevant for the nationality non-discrimination provision. No objective, commendable as it may be, can justify a measure which is found to be discriminatory under Art. 24. By shifting the 'other or more burdensome'-test towards an overall burden-test, the Court seeks to incorporate the purpose and the eventual effect into the second step of the decision tree. However, such considerations are not relevant for the test to be made under the second step. As soon as the taxation is other or more burdensome, the treatment is discriminatory. The fact that the taxpayer benefits from other provisions, in his home State or in the source State, which render his overall tax burden comparable to a national of the source State, is irrelevant (even if the foreign taxpayer would be better off in the end) (see supra, 2.B.VI.A).

C. Article 24(2): stateless persons

I. The 1954 Convention relating to the Status of Stateless Persons

The precarious legal position of stateless persons has created several issues, including issues with regard to taxation. In order to improve their legal position, the 1954 Convention relating to the Status of Stateless Persons was concluded[378]. The Convention defines a stateless person in Art. 1 as *"a person who is not considered as a national by any State under the operation of its law."* Certain categories of persons are excluded, however: persons receiving protection from certain United Nations agencies, persons who are recognized by the competent authorities of their country of residence as having the rights and obligations which are attached to the possession of the nationality of that country, and certain criminals[379].

The 1954 Convention requires the Contracting States to refrain from discriminating against stateless persons in different areas. With regard to taxation, Art. 29(1) provides: *"The*

[378] *Convention relating to the Status of Stateless Persons*, done at New York on 28 September 1954. As of 15 October 2009, there are 65 States parties to the Convention.
[379] Art. 1(2) of the 1954 Convention.

Contracting States shall not impose upon stateless persons duties, charges or taxes, of any description whatsoever, other or higher than those which are or may be levied on their nationals in similar situations." Thus, the Convention requires Contracting States to refrain from imposing fiscal charges which are 'other or higher' than those which are or maybe levied on nationals in similar situations[380].

II. The OECD MC

When Working Party no. 4 of the OEEC Fiscal Committee drafted its first report in 1957, it referred to Art. 29(1) of the 1954 Convention and proposed to include a non-discrimination provision on stateless persons[381]. That proposal has evolved into the current Art. 24(2) OECD MC, which still bears some similarities to Art. 29(1) of the 1954 Convention[382]. However, under Art. 24(2) OECD MC the treatment must not be 'other or more burdensome' than the national treatment, whereas the 1954 Convention refers to treatment which is 'other or higher'[383]. It can be assumed that 'higher taxation', when used as an alternative to 'more burdensome taxation', is synonymous with the latter expression (cf. supra). Furthermore, for the definition of 'stateless persons', the OECD Commentary on Art. 24 refers to the 1954 Convention, without, however, excluding the three categories of persons mentioned in Art. 1(2) of the 1954 Convention[384]. As a result, the personal scope of the non-discrimination provision for stateless persons is wider under the OECD MC than under the 1954 Convention. Given the reference to the definition of stateless persons under public international law, which applies exclusively to individuals, the field of application of Art. 24(2) OECD MC is limited to individuals[385]. Stateless companies (leaving aside the question whether such a company is able to exist[386]) are therefore not protected.

---

380 Art. 29(2) of the 1954 Convention provides for the following exception: *"Nothing in the above paragraph shall prevent the application to stateless persons of the laws and regulations concerning charges in respect of the issue to aliens of administrative documents including identity papers."*

381 FC/WP4(57) 1, 5. See 1.C.I.

382 It should be mentioned that Art. 24(2) is only rarely included in treaties. In 1991, it was reported that a provision on stateless persons was included in only 72 out of a total of about 1000 treaties; J. AVERY JONES, *et al.*, "The non-discrimination article in tax treaties", *European Taxation* 1991, 323. The national reports compiled in the context of the 2008 IFA Congress confirm that this provision is rarely included: IFA, *Cahiers de droit fiscal international. Non-discrimination at the crossroads of international taxation*, Vol. 93a, Amersfoort, Sdu Fiscale & Financiële Uitgevers, 2008. Perhaps States feel that the inclusion of Art. 24(2) in tax treaties might be superfluous, given the protection offered by the 1954 Convention; cf. for instance the Spanish National Report for the 2008 IFA Congress: *"Likewise, we believe that when the two contracting states have ratified the New York Convention, addition of the provision of article 24(2) MC may be superfluous and even contradictory, since article 29 of the Convention does not require tax residence in one of the contracting states, thereby implying a wider subjective scope of application"* (*ibid.*, 552).

383 As indicated earlier, the 1957 proposal of Working Party no. 4 referred to taxes which are *"other, higher, or more burdensome"*.

384 Comm. OECD on Art. 24, para. 32. Interestingly, the 1963 Comm. OECD on Art. 24(2) stated the following: *"On 28th September, 1954, a number of states concluded a Convention relating to the status of stateless persons, under Article 29 of which stateless persons must be accorded national treatment. The signatories of the Convention include several OECD Member countries. Such a provision, however, is only suitable for insertion in a multilateral Convention."*

385 K. VOGEL, *o.c.*, 1303.

386 According to Rigaux, a legal person cannot be stateless, as it derives its existence and status from some system of law. F. RIGAUX, *Droit International Privé. 1. Théorie Générale*, Larcier, Brussels, 1987, no. 135, p. 94. Concurring: K. VAN RAAD, *o.c.*, 86. See also J. AVERY JONES, *et al.*, "The non-discrimination article in tax treaties", *European Taxation* 2001, 323.

In the 1963 version of the OECD MC provision on stateless persons, no requirement of residence in either Contracting State was included. As a result, a stateless person, wherever resident, can invoke this provision. For instance, a stateless person, resident in State X, derives income from State A. State A does not have a tax treaty with State X. However, the stateless person can invoke the provision on stateless persons included in any tax treaty concluded by State A if that provision is identical to the provision in the 1963 OECD MC. By contrast, a State X resident who is also a State X national, would not be able to invoke a tax treaty non-discrimination provision.

In order to avoid such situations, the scope of the provision has been restricted in the 1977 MC[387]. By adding *"who are residents of a Contracting State"* (see supra), it was made clear that a stateless person wishing to invoke the non-discrimination provision of a tax treaty must reside in a Contracting State. It has been argued, however, that even without this addition, the stateless persons-provision of the 1977 OECD MC only applied to stateless persons residing in a Contracting State[388], as the 1977 OECD MC added a sentence to the provision on nationality discrimination (Art. 24(1)) which explicitly excludes application of the Article 1 residence requirement (cf. supra). From this explicit exclusion, it might be inferred that the residence requirement of Article 1 does apply to Art. 24(2), since that paragraph does not contain such an explicit exclusion. This conclusion is supported by para. 16 of the OECD Commentary on Art. 24 which indicates that States may want to extend Art. 24(2) to all stateless persons, whether resident or not. In order to do so, the Commentary adds, they should delete the residence requirement (*"who are residents of a Contracting State"*) and explicitly exclude application of the Art. 1 residence requirement (*"notwithstanding the provisions of Art. 1"*), as is done in Art. 24(1).

The restriction to resident stateless persons brought about by the 1977 OECD MC may cause friction with Art. 29(1) of the 1954 Convention on Stateless Persons, as the latter provision does not contain such a restriction. States which are party to the 1954 Convention, and which also have concluded tax treaties according to the current OECD MC may have bound themselves to conflicting obligations. Under the 1954 Convention they are obliged to non-discriminatory tax treatment of stateless persons, whether resident or not. Under the tax treaty, however, they are only prohibited from discriminating against stateless persons who reside in a Contracting State. The question thus arises whether a State can first bind itself to a certain obligation in a multilateral treaty, and later restrict this obligation in relation to another State by means of a bilateral treaty.

In the absence of an express treaty clause dealing with conflicts, resort must be had to the general principles governing the interpretation and application of treaties. The intention of the States concluding the second treaty must therefore be taken into consideration[389]. From the OECD Commentary[390], it is clear that the changes brought about by the 1977 OECD MC

[387] Cf. Comm. OECD on Art. 24, para. 14-15.
[388] K. VAN RAAD, *Nondiscrimination in international tax law*, 87.
[389] *"The effect of the second treaty upon the prior treaty is essentially a question of what the contracting States intend when they conclude the second treaty. They may intend simply to supplement the earlier treaty or to revise it"*, Special Rapporteur H. WALDOCK, as quoted by J. B. MUS, "Conflicts between treaties in international law", *N.I.L.R.* 1998, 217.
[390] In the absence of any express statements of contracting States as to their intentions when concluding a tax treaty, the OECD Commentary can be a useful tool in finding the object and purpose of certain treaty provision. On the role of the OECD Commentary, see *inter alia*, H. PIJL, "The OECD Commentary as a Source of International Law and the Role of the Judiciary", *European Taxation* 2006, 216-224; D. WARD *et alia*, *The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model*,

were specifically aimed at restricting the scope of the stateless persons provision (cf. supra). The repeated reference to the 1954 Convention in the OECD Commentary, and the express confirmation that the changed wording of the 1977 OECD MC is aimed at restricting the scope of Art. 24(2) OECD MC to stateless persons residing in a contracting State, might indicate that the drafters of the OECD MC were well aware of the conflicting scopes of both instruments. However, no definite answer on priority can be inferred from the OECD Commentary. If the conflicting treaties lack a conflict clause, and treaty interpretation is not conclusive, the rules laid down in Art. 30(3) and (4) VC should be applied[391]:

• When all the parties to the earlier treaty are parties also to the later treaty but the earlier treaty is not terminated or suspended, the earlier treaty applies only to the extent that its provisions are compatible with those of the later treaty. (Art. 30(3) VC). This is an application of the principle *'lex posterior derogat lege priori'*.

• When the parties to the later treaty do not include all the parties to the earlier treaty:
  (*a*) as between States Parties to both treaties the lex posterior rule set out above applies (Art. 30(4)(a) VC);
  (*b*) as between a State party to both treaties and a State party to only one of the treaties, the treaty to which both States are parties governs their mutual rights and obligations (Art. 30(4)(b) VC).

Applying these rules to the conflicting provisions of the 1954 Convention and a tax treaty following the OECD MC would lead to the following results:

• If both tax treaty partners are parties to the 1954 Convention, the later treaty takes precedence over the earlier treaty. Consequently, if the tax treaty was concluded after both States have acceded to the 1954 Convention, the discriminating State is no longer bound by the stricter non-discrimination provision of the 1954 Convention. In the bilateral relation between both tax treaty partners, the later tax treaty prevails.

• If only one of the tax treaty partners has acceded to the 1954 Convention before concluding the tax treaty, three situations must be distinguished[392]:
  - if the discriminating State is not a party to the 1954 Convention, no conflict occurs. The discriminating State is not bound by the more stringent 1954 rules, and is allowed to restrict non-discriminatory treatment to stateless persons who are resident of either tax treaty State.
  - if the discriminating State was not a party to the 1954 Convention when concluding the tax treaty, but became a party thereto at a later date, it is bound by the more stringent rules of the 1954 Convention (*lex posterior*);

Amsterdam, IBFD Publications, 2005; F. ENGELEN, *Interpretation of tax treaties under international law*, Amsterdam, IBFD Publications, 2004, 425 *et seq.*; K. VOGEL, "The influence of the OECD Commentaries on treaty interpretation", *Bulletin for International Fiscal Documentation*, 2000, no. 12, 612 *et seq.*

391 The *lex posterior* rule, which is the basis of Art. 30 (3) and (4) is only meant as a last resort when treaty interpretation has failed to determine priority. In the words of Special Rapporteur H. WALDOCK: *"The rules in paragraphs 3, 4 and 5 were thus designed essentially as residuary rules"*, as quoted in I. M. SINCLAIR, *The Vienna Convention on the Law of Treaties*, Dover, Manchester University Press, 1984, 97.

392 It may be quite difficult to determine which treaty is earlier. This issue is not addressed here; I refer to doctrine dealing with possible criteria, e.g. E. W. VIERDAG, "The time of the conclusion of a multilateral treaty: Article 30 of the Vienna Convention on the Law of Treaties and related provisions", *B.Y.I.L.* 1988, 75-111; J. B. MUS, "Conflicts between treaties in international law", *N.I.L.R.* 1998, 218-227.

unless the other tax treaty partner is not a party to the 1954 Convention, in which case the next rule applies

- if the discriminating State is a party to the 1954 Convention, but the other tax treaty partner is not, it could be held that the 1954 Convention has no role to play, as the discriminating State has not bound itself to the more stringent rules of that Convention in its relation to the other tax treaty partner.

As logical as the priority system of Art. 30 VC may seem, it offers little help in solving the current issue. The problem, of course, is the nature of the rule contained in the 1954 Convention. Take, for instance, State A and B who conclude a tax treaty based on the 1977 OECD MC. State A is a party to the 1954 Convention, but State B is not. X is a stateless person residing in State C, State C being a party to the 1954 Convention. In case X is being fiscally discriminated against in State A, can State A refer to the tax treaty between State A and State B to restrict its non-discrimination obligations to stateless persons who reside in either State A or State B? I do not think this is possible, as this would violate State A's obligation under the 1954 Convention with regard to State C residents. Thus, the universal nature of the obligations imposed by the 1954 Convention renders it impossible for States to escape them via bilateral tax treaties. If the stateless person is a resident of neither tax treaty partner, he can invoke the 1954 provision. If, on the other hand, he is a resident of one of the tax treaty partners, he can invoke the Art. 24(2)-style provision in the tax treaty as well[393].

Moreover, para. 17 of the Commentary offers a narrower alternative to Art. 24(2). According to the Commentary, certain States will find Art. 24(2) to be too liberal, *"insofar as they entitle stateless persons who are residents of one State to claim equality of treatment not only in the other State but also in their State of residence and thus benefit in particular in the latter from the provision of double taxation conventions concluded by it with third States."* In order to avoid this, the Commentary offers an alternative, under which the residence State is exempt from the prohibition of nationality discrimination against stateless persons; the stateless person is only entitled to protection from nationality discrimination in respect of the other State. It should be added, however, that such an addition is only meaningful if the residence State restricts access to tax treaties to nationals, rather than residents. If not, the resident stateless person can benefit from the treaty on the basis of his residence; their entitlement to national treatment (or the lack thereof) in the residence State does not change anything in that regard. Entitlement to national treatment in the residence State is of importance solely for those provisions of domestic tax law and tax treaty law which deal with nationality (and such provisions are quite rare).

D. Article 24(3): permanent establishments

As illustrated in I.D, the non-discrimination provision on permanent establishments has changed very little since its introduction in the 1963 Draft Convention. Moreover, it is clear that the wording of this provision is, to a considerable extent, inspired by the work of the OEEC Fiscal Committee in the 1950's (see I.C).

[393] Cf. also K. VAN RAAD, *Nondiscrimination in international tax law*, 87-88, who holds that the 'self-executing' nature of Art. 29 of the 1954 Convention entitles stateless persons to invoke the broader protection contained therein *vis-à-vis* States party to the 1954 Convention, who have concluded a tax treaty which subject the protection of stateless persons to a condition of residence.

The basic purpose of the provision is to ensure that the PE which an enterprise of one contracting State has in the other contracting State is not treated less favourably than enterprises of the latter contracting State carrying on the same activities. It is important to stress that Art. 24(3) is fundamentally different from Art. 24(1) in that it does not prohibit discrimination on the basis of nationality, but on the basis of the situs of an enterprise. Accordingly, it applies irrespective of nationality to all residents of a contracting State who have a PE in the other contracting State[394].

It is important to read Art. 24(3) in combination with Art. 7 OECD MC. Art. 7 confers on the PE State the right to tax the business profits that can be attributed to the PE. This is the framework in which Art. 24(3) applies; i.e. Art. 24(3) presupposes that the taxation of the PE will be limited in cause and amount as provided for by Art. 7 (i.e. unless a more specific provision supersedes Art. 7)[395]. The Commentary stresses this by pointing out that the purpose of Art. 24(3) "*is to end all discrimination in the treatment of permanent establishments as compared with resident enterprises belonging to the same sector of activities, **as regards taxes based on business activities, and especially taxes on business profits***" (emphasis added)[396]. Yet, it has been argued that the protection offered by Art. 24(3) concerns the entire taxation of the PE, and is therefore not restricted to the business profits attributable to it[397]. The reason for this is that Art. 24(3) refers to 'the taxation on a permanent establishment' without restriction as to the type of income. Thus, if the non-resident earns for instance income from immovable property (which falls under Art. 6 rather than Art. 7), the taxation of this income would also be covered by Art. 24(3)[398]. Another argument that has been brought forward in this regard is that Art. 24(6) states that Art. 24 applies to taxes of every kind and description, notwithstanding the provisions of Art. 2. This would imply that Art. 24(3) applies to the taxation of certain items of income, such as income from immovable property, even though such taxation is not governed by the distribute rule of Art. 7[399].

However, I find no support for this position in the Model or the Commentary. It seems to me that, by stressing that Art. 24(3) is intended to end discrimination as regards taxes based on business activities, the Commentary clearly limits the scope of application to the taxation of profits attributed to the PE under Art. 7. I interpret the reference in Art. 24(3) to 'the taxation on a permanent establishment' as 'the taxation on a permanent establishment in accordance with the provisions of the treaty', that is to say, in accordance with Art. 7. More specifically, Art. 7 defines how the 'taxation on a permanent establishment' takes place in the PE State: that State is only allowed to tax the business profits attributable to the PE. Consequently, if a non-resident is taxed in respect of immovable property which he has in the PE State, he is not taxed 'on a permanent establishment', but on immovable property situated in that State. As the treaty does not consider this to form part of the PE's business profits, Art. 24(3) does not apply since this is not 'taxation on a permanent establishment' within the meaning of that

394 See Comm. OECD on Art. 24, para. 33.
395 It is assumed here that the attribution of profits to the PE is governed by Art. 7. Consequently, the question whether a Contracting State is allowed to tax a PE on the basis of the 'force of attraction' principle should be answered, first and foremost, on the basis of Art. 7. From a theoretical point of view, however, such treatment could be seen as discriminatory insofar the PE State does not allocate profits in the same way to residents. See also K. VAN RAAD, *o.c.*, 149 and K. VOGEL and M. LEHNER, *Doppelbesteuerungsabkommen*, Verlag C.H. Beck, München, 2008, 5 Auflage, 1722.
396 Comm. OECD on Art. 24, para. 35.
397 K. VOGEL, *o.c.*, 1314. See also the interpretation of the term 'taxation', discussed in 2.D.III.A.
398 K. VAN RAAD, *o.c.*, 135-137.
399 N. SACCARDO, "Art. 24(3) of the OECD Model Convention: the significance of the expression 'taxation on a permanent establishment' in cross-border reorganizations", *Intertax* 2003, 276.

provision[400]. The fact that Art. 24 applies to taxes of every kind and description by virtue of paragraph 6 does not alter this conclusion. Art. 24(6) is intended to clarify that the non-discrimination provision also applies to certain taxes to which the rest of the treaty does not apply, e.g. excise taxes, registration taxes, etc. (see 2.G). Accordingly, Art. 24(6) is only intended to broaden the scope of Art. 24 as compared to the rest of the treaty. Art. 24(6) does not imply that distributive rules should be disregarded when applying Art. 24. More specifically, that provision does not mean that Art. 24(3) is no longer restricted to income attributed to the PE under Art. 7. As clarified by the Commentary, Art. 24(3) is concerned with discrimination of PEs as regards taxation on their business activities. Art. 24(6) only adds that the 'taxation' referred to concerns taxes of every kind and description.

As to the scope of application, it should also be noted that Art. 24(3) OECD MC applies irrespective of whether it concerns the PE of a company or an individual. Where the PE of a partnership is concerned, the enterprise it runs is, as a whole, an 'enterprise of a contracting State' within the meaning of Art. 24(3), provided that the partnership as such is a person for purposes of the treaty and is a resident of the contracting State in question. If, conversely, the partnership is not a person for tax treaty purposes, the partners are considered to be the 'owners' of the PE. In such a case, the non-discrimination provision applies if the partners are resident in the contracting State, regardless of the State in which the partnership itself exists[401]. If not all of the partners are residents of that contracting State, the non-discrimination provision only applies to the share attributable to the resident partners[402].

---

[400] This conclusion implies that the question whether immovable property constitutes a PE is of paramount importance. As an example, consider the former Belgian domestic rules on the taxation of non-residents. Under those rules, the tax rate on non-resident companies was higher than the tax rate on resident companies (see Art. 246 ITC 1992; this difference in treatment was removed in 1996). However, non-resident companies with a PE in Belgium were entitled to the lower rate if a tax treaty with a PE non-discrimination clause applied. On the other hand, the reduction did not apply where the non-resident company earned income from immovable property in Belgium that could not be attributed to a Belgian PE. Nevertheless, in order to simplify the rates in the Belgian non-residents' income tax, the Belgian tax authorities' Official Commentary on the tax treaties concluded by Belgium provided that the reduced rate also applied in the latter case (*Com. Ov.* 6/34).

[401] E.g. Bundesverfassungshof 8 January 1969, No. 158/64, *BStBl II*, 1969, 466, concerning the 1931 tax treaty between Germany and Switzerland. A Swiss resident was a partner in a German partnership that carried on business in Germany. Given the transparent treatment of the partnership (both in Germany and in Switzerland), the partner was considered to be the 'owner' of the PE in Germany. As a result, Art. 24(3) was applicable (see § 18 of the judgment: *"Als Unternehmen eines Vertragsstaats sind […] Unternehmen anzusehen, deren Inhaber ihren Wohnsitz in einem Vertragsstaat haben, gleichgültig wo sich die Betriebstätten befinden. Diese aus Art. 3 Abs. 1d des OECD-Musterabkommens entnommene Begriffsbestimmung erscheint gerechtfertigt, da Art. 12A Abs. 3 DBAS wörtlich aus dem OECD-Abkommen entnommen ist* [i.e. Art. 24(3) OECD MC] *und wird auch durch die Fassung des Abs. 3 Nr. 2 bestätigt. Diese Definition ist auf die Gesellschafter von Personengesellschaften, die in einem Vertragsstaat als Mitunternehmer behandelt werden - dies geschieht sowohl in der Bundesrepublik als auch in der Schweiz - entsprechend anwendbar. Hier ist also der Gesellschaftsanteil einer Person mit Wohnsitz in einem Vertragsstaat als Unternehmen dieses Vertragsstaats anzusehen. Sowohl in der Schweiz als in der Bundesrepublik werden ferner sowohl nach innerem Recht als auch nach Art. 3 Abs. 4 DBAS Anteile an einer OHG als Beteiligungen an gesellschaftlichen Unternehmen hinsichtlich der Einkünfte und Vermögen wie Einzelunternehmen in den Vertragsstaaten besteuert, in denen sich Betriebstätten befinden."*)

[402] K. VOGEL, *o.c.*, 1313-1314. See also P. ADONNINO, "General Report", in IFA, *Non-discrimination rules in international taxation. Cahiers de droit fiscal international,* Vol. LXXVIIIb, Amersfoort, Sdu Fiscale & Financiële Uitgevers, 1993, 55.

I. Entitlement to Article 24(3): what is 'an enterprise'?

Art. 24(3) OECD Model intends to ensure non-discriminatory taxation of the PE which 'an enterprise' of a contracting State has in the other contracting State. This term is also used in Art. 24(4) and (5) (see infra). According to Article 3(1)(c) of the OECD Model, the term 'enterprise' *"applies to the carrying on of any business."* Art. 3(1)(d) adds that the term 'enterprise of a Contracting State' means *"an enterprise carried on by a resident of a Contracting State"*. Art. 3(1)(h) further provides that the term 'business' includes the performance of professional services and of other activities of an indepent character[403].

The reference to 'business' in Article 3(1)(c) should be interpreted in line with Article 7, on business profits. Accordingly, all other types of activities from which income may be qualified under tax treaty provisions other than Article 7 should be excluded[404]. For instance, income from agriculture or forestry, which qualifies under Art. 6 OECD MC, is not covered by Art. 24(3).

Admittedly, this definition of the term 'enterprise' is not very helpful. Throughout the history of the Model Convention, the drafters have encountered considerable difficulties in finding an acceptable definition of this term, which might explain the limited scope of the current definition[405].

> Consider, for instance, the definition used in the London Draft: *"The term 'enterprise' includes any kind of enterprise whether it belongs to an individual, a partnership, a company or any other legal entity or de facto body"*[406]. The OEEC also had some difficulties with this concept. Originally, Working Party no. 4 used the term 'operator' (or 'entrepreneur' in the final draft)[407]. It was suggested that the term 'enterprise' might be preferable, but the Working Party disagreed, pointing out that *"the word 'entrepreneur' has been adopted because it has the merit of designating both individuals and legal persons and of thus being applicable where it is not the enterprise itself that is taxed but the individual*

[403] In 2000, Article 14 of the OECD MC, on independent personal services, was deleted. At the same time, Art. 3(1)(c) was changed (to *"the term 'enterprise' applies to the carrying on of any business"*) and Art. 3(1)(h) was added (*"term 'business' includes the performance of professional services and of other activities of an indepent character"*). Before this change, Art. 24(3) did not apply to to PEs of self-employed (or otherwise independent) taxpayers. As a result of these changes, income from independent personal services now fall under Art. 7 and Art. 24(3) applies to such activities when they are carried out through a PE (see also K. VOGEL and M. LEHNER, *Doppelbesteuerungsabkommen*, Verlag C.H. Beck, München, 2008, 5 Auflage, 1717).

[404] See also K. VAN RAAD, *Nondiscrimination in international tax law*, Deventer, Kluwer, 1986, 136.

[405] For an extensive discussion of the meaning of the term 'enterprise', see G. MAISTO (ed.), *The meaning of 'enterprise', 'business' and 'business profits' under tax treaties and EU tax law*, Amsterdam: IBFD Publications, 2011.

[406] See also the definition given in the 1933 League of Nations Draft Convention for the Allocation of Business Income between States for the Purposes of Taxation: *"As used in this convention, the term 'enterprise' includes every form of undertaking, whether carried on by an individual, partnership, corporation or any other entity."*

[407] See supra, 1.C.

carrying on the enterprise"[408]. The Fiscal Committee ultimately reached the opposite conclusion and changed 'entrepreneur' to 'enterprise'[409].

The OECD Commentary is also quite concise on this issue, only pointing out that the question whether an activity is performed within an enterprise or is deemed to constitute in itself an enterprise is to be interpreted according to domestic law of the contracting States. For that reason, no exhaustive definition of the term 'enterprise' is given in the Model. However, the fact that the Model expressly states that an enterprise applies to the carrying on of any business, and 'business' is defined to include the performance of professional services and of other activities of an indepent character, implies that these activities must be considered to constitute an enterprise, regardless of the meaning of the term under domestic law[410].

According to Article 1 OECD MC, only a person who is a resident of a contracting State can claim treaty entitlement. Therefore, the treaty protection of an enterprise (including the protection offered by the non-discrimination provision) depends on the residence of the person that carries on the enterprise, rather than the place where the enterprise is carried on. Consequently, an enterprise owned by a resident of State A and carrying on business exclusively in State B is an 'enterprise of State A' even if it has no assets nor engages in any activities in that State. Conversely, an enterprise carried on in State A does not enjoy treaty protection under the treaty between State A and B if the entrepreneur is a resident of State C. However, if this enterprise takes on the legal form of a body corporate or any other legal form that qualifies as a person, it may qualify as a resident of a contracting State by virtue of this legal form under Art. 4. In such a case, it becomes an enterprise of that contracting State[411].

The Commentary's reference to domestic law in order to determine whether an activity constitutes an enterprise is problematic for most common law countries, since the term is not

---

[408] FC/WP4(58) 1, 8-9. See also FC/WP4(57) 3, 12: *"In June last the Committee instructed the Working Party to consider whether the word 'entrepreneur' ('operator') in paragraph (4) should not be replaced by the word 'enterprise' ('enterprise'). It seems to the Working Party that the choice between these two terms should for preference depend on the terminology used in the Convention in which the provision in question will be inserted. The Working Party proposes that the word 'entrepreneur' should be maintained for the time being, and would observe that it very frequently happens that it is not the enterprise itself that is taxed but the individual who operates it. The advantage of the word 'entrepreneur' is that it applies both to individuals and to legal persons and taxpayers assimilated thereto."*

[409] The Committee pointed out that *"the question was raised whether it would not be better to use the word 'entrepreneur' instead which had the merit of designating both individuals and legal persons and of thus being applicable where it is not the enterprise itself that is taxes but the individual carrying on the enterprise. The word 'enterprise' was finally selected, it being understood that the choice between the two terms might depend on the terminology used in the Convention in which the provision is to appear"* (FC(58) 2 (1st Revision) Part II, 27).

[410] Comm. OECD on Art. 3, para. 4 and 10.2.

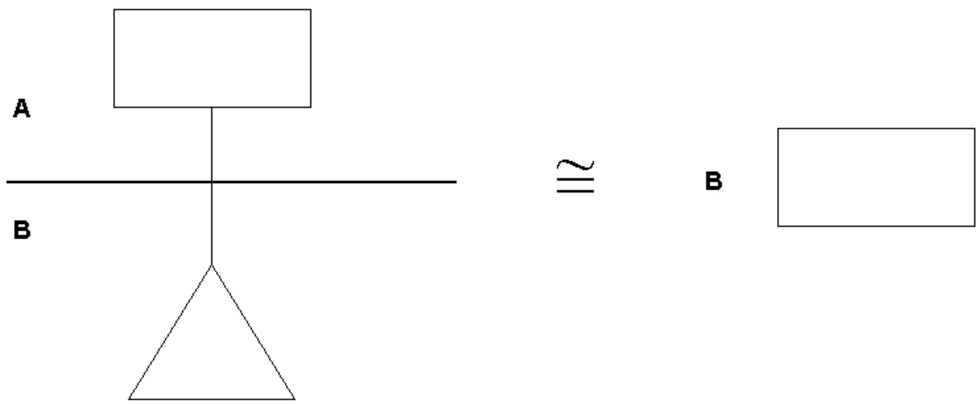
[411] K. VOGEL, *o.c.*, 184-185. Art. 4(1) defines a resident of a Contracting State as *"any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature […]"*. It has been argued that the expression 'any other criterion of a similar nature' also includes nationality, with the result that, where a Contracting State attaches unlimited liability to tax to nationality, a national of that State is also a resident of that State (see K. VAN RAAD, *o.c.*, 130-132). As a result of this interpretation, a taxpayer may be able to invoke both Art. 24(1) and Art. 24(3). However, it should be pointed out that, in order to be a resident of a Contracting State, a person must be linked to that State by a connecting factor which is generally recognised as justifying worldwide tax liability (see P. BAKER, *Double taxation conventions*, London, Sweet & Maxwell, 2006 (loose-leaf), 4B.07 and K. VOGEL, *o.c.*, 233, who points out that criteria for residence must be 'locality-related'). That does not include nationality, so nationality is not 'a criterion of a similar nature'. The situation may be different for companies, as in common law countries the State of incorporation is regarded as the domicile of the company (see J. AVERY JONES et al., "The origins of concepts and expressions used in the OECD Model and their adoption by States", *B.T.R.* 2006, 716).

universally used in the legal system of those countries[412]. Moreover, the translation in the Model is not entirely clear for those countries. In French, 'entreprise' can mean either the person or the activity (i.e. 'any business'), depending on the context. It is used in the same way in the English version of the Model, but this is confusing as it is not normal English usage[413]. Moreover, in many civil law countries (e.g. Belgium, France, Germany), a resident commercial company is always considered as carrying on an enterprise, even if its activities consist of passive investment. In contrast, in most common law countries, a company may or may not be carrying on a business, depending on its activities and, consequently, may or may not be carrying on an enterprise. As a result, it is possible that the scope of application of the PE non-discrimination provision is narrower in common law countries[414]. Obviously, this is not a desirable result.

II. The comparability test: 'an enterprise carrying on the same activities'

II.A. General

The comparison to be made under Art. 24(3) is between the PE which a resident of a contracting State has in the other contracting State (subject of comparison) and a resident of the latter State 'carrying on the same activities' (object of comparison)[415]. Schematically, this can be represented as follows:



[412] J. AVERY JONES et al., "The origins of concepts and expressions used in the OECD Model and their adoption by States", *B.T.R.* 2006, 701. See, for instance, Lord Radcliffe in House of Lords, 16 July 1959, *Ostime (Inspector of Taxes) v Australian Mutual Provident Society*, (1960) *A.C.* 459: *"For our purpose it is convenient to note that the language employed in this agreement is what may be called international tax language and that such categories as 'enterprise', 'commercial or industrial profits' and 'permanent establishment' have no exact counterpart in the taxing code of the United Kingdom."*

[413] See K. VAN RAAD, "The term 'enterprise' in the Model Double Taxation Conventions – Seventy years of confusion", *Intertax* 1994, 492-493, who divides the OECD MC provisions in which the term is used into three groups: provisions where the term refers to the person, provisions where it refers to the activity, and provisions where it can mean both the person and the activity. He includes the PE non-discrimination provision in the third category. For a general discussion, see also J. AVERY JONES, "Does 'enterprise' in the OECD Model mean 'business'?", *Bull. IBFD* 2006, 476-479.

[414] J. AVERY JONES, "The non-discrimination Article in tax treaties: Part 2", *B.T.R.* 1991, 422-423.

[415] Several treaties refer to "carrying on the same activities in the same circumstances", e.g. Art. 23(1)(d) of the 1982 treaty between Australia and the US, Art. 22(4) of the 1968 treaty between France and Ireland, Art. 26(5) of the 1973 treaty between France and Spain.

a. 'Carrying on the same activities'

The core issue in respect of this comparison is determining what is meant by 'carrying on the same activities'. The Commentary notes that the comparison is to be made with *"resident enterprises belonging to the same sector of activities, as regards taxes based on business activities, and especially taxes on business profits"*. Moreover, the object of comparison should have *"a legal structure that is similar to that of the enterprise to which the permanent establishment belongs."* As an example, the Commentary provides that the PE of an enterprise carried on by a non-resident individual cannot be compared to a resident company. Consequently, the PE of a non-resident individual should be compared to a resident individual, while the PE of a non-resident company should be compared to a resident company[416].

Moreover, *"regulated and unregulated activities would generally not constitute the 'same activities' for the purposes of paragraph 3."* The Commentary gives two examples here. First, a PE whose activities include the borrowing and lending of money but which is not registered as a bank cannot be compared to a domestic bank, since they do not carry on the same activities. Secondly, activities which an enterprise of a contracting State performs in the other contracting State through a PE cannot be compared to activities carried on by a State or its public bodies, since they are controlled by the State[417].

As the Commentary is not entirely conclusive, there is some discussion as regards the correct interpretation of the phrase 'carrying on the same activities'. According to ADONNINO, 'the same activities' as it is used in Art. 24(3) is not the same as 'the same circumstances' as it is used in Art. 24(1). He argues that the former expression can only refer to the 'object of the activities', i.e. the field in which the PE is active, whereas the latter concerns the legal and factual circumstances in which the object is pursued. By contrast, VAN RAAD essentially argues that both expressions should be interpreted in the same way. He notes that a restriction of the comparability-test to the activities of the enterprise would imply that national rules that differentiate not on the basis of the activities performed but on any other basis would not be available to non-residents; for instance, measures that differentiate on the basis of the structure of the assets (e.g. special regimes for investment companies). He argues that this cannot have been intended. Therefore, the 'same activities' test should be applied as supplemented by an implied 'same circumstances' test[418].

> This argument is not very convincing. A measure is discriminatory when it differentiates 'on the basis of' a prohibited criterion between two comparable groups, that is to say, when all relevant characteristics apart from the prohibited criterion (i.e. the comparative attribute) are identical. Here, the prohibited criterion is the residence of the taxpayer having a PE in a contracting State. Such a PE must not be subject to less favourable taxation than a comparable resident taxpayer. In order to find a comparable resident taxpayer, regard should be had to the activities carried out by the subject and object of comparison, insofar as those

[416] For an example, see Income Tax Appellate Tribunal (Mumbai Bench), *Mashreqbank psc v Deputy Director of Income Tax*, 13 April 2007, 9 *ITLR* 1062: a company incorporated in the U.A.E. carrying on banking activities in India through a PE had to be compared to an Indian company (i.e. the legal form of the taxpayer to which the PE belongs) carrying on banking activities in India (i.e. the activities carried out by the PE).

[417] Comm. OECD on Art. 24, para. 35, 37-38.

[418] K. VAN RAAD, *Nondiscrimination in international tax law*, Deventer, Kluwer, 1986, 140. As noted earlier, VAN RAAD also argues that the 'same circumstances' test is redundant. Apparently, he feels the same way about the 'same activities' test. See also J. O'BRIEN, "Nondiscrimination in tax treaties", *Law and Policy in International Business* 1978, 568-569.

activities are relevant from the perspective of the domestic measure at issue. So it would be incorrect to assume that measures that do not differentiate on the basis of activities performed automatically fall outside the scope of application of Art. 24(3).

A first observation to made in this regard is that the reason why the OECD MC does not require 'the same circumstances' where PEs are involved, is most likely that the PE of a non-resident is, by definition, not in the same circumstances as a resident. PEs are not separate legal entities but form part of an enterprise, the head office of which is in another State. As a result, there will always be important differences between a PE and a resident[419]. For instance, residence cannot be taken into account when comparing the PE of a non-resident taxpayer to a resident taxpayer. By contrast, residence is of the utmost importance in the comparability-test under Art. 24(1). It is therefore understandable that the drafters of the OECD MC chose not to transpose the 'same circumstances' terminology to Art. 24(3), but, as will be pointed out below, 'same activities' might not have been the best alternative.

On the basis of this analysis, it seems incorrect to interpret 'in the same circumstances' and 'carrying on the same activities' identically. Arguably, the 'same circumstances' to which Art. 24(1) refers, may include the activities which the subject and object of comparison perform, insofar as these activities are relevant for tax purposes. For instance, it could be argued that a foreign company that is only engaged in passive holding activities cannot be compared to a national company that is engaged in industrial activities. Depending on the domestic measure at issue, the nature of their activities may have repercussions on their tax position, which would mean that they are not in 'the same circumstances'. In my opinion, the same condition applies in respect of Art. 24(3): only where the activities performed are **relevant** for the taxation of the PE, should they be taken into consideration in the comparison[420].

On the other hand, it seems that a mere consideration of the 'activities' in which the PE is engaged, is overly restrictive. The comparison should be controlled by all of the elements that are relevant to the taxation of the PE. It is possible that this includes the PE's activities, but it should not be limited to that aspect. Other aspects might be relevant as well. For instance, and this is a major point of controversy[421], it might be necessary to look at the entire non-resident entity and not just at the PE. As a general starting point, it could be argued that the non-resident entity as a whole should be considered where this is relevant for the taxation of the PE. If not, there is no reason to look beyond the PE level. These issues will be addressed hereafter, on the basis of case law.

b. Separate entity approach

Even though this is a subject that goes well beyond the scope of this study, it is necessary to refer to the so-called 'separate entity approach' as regards the taxation of PEs. There is an inherent dilemma in the assumption that the subject of comparison is the PE in itself, i.e. that

---

[419] See also Comm. OECD on Art. 24, para. 39, where it is pointed out that the application of Art. 24(3) may give rise to considerable difficulty: *"The main reason for difficulty seems to reside in the actual nature of the permanent establishment, which is not a separate legal entity but only a part of an enterprise that has its head office in another State. The situation of the permanent establishment is different from that of a domestic enterprise, which constitutes a single entity all of whose activities, with their fiscal implications, can be fully brought within the purview of the State where it has its head office."*

[420] See, for instance, the discussion of the *UBS*-case in 2.D.II.B.b.3.

[421] E.g. L. FRIEDLANDER, "The role of non-discrimination clauses in bilateral income tax treaties after GATT 1994", *British Tax Review* 2002, 2, 83; W. GIFFORD, "Permanent establishments under the nondiscrimination clause in income tax treaties", *Cornell International Law Journal* 1978, 51, 61.

the PE can be seen as a separate entity, to be compared with resident enterprises. The very idea that the PE is a separate entity is based on a fiction, and therefore difficult to apply in practice. This notion, that the subject of comparison should be constructed by considering the PE in isolation, has to be seen against the light of Article 7 OECD MC.

In fact, the concept 'permanent establishment' in Art. 7 functions on two levels. Its first purpose is to ensure a fair distribution of taxing rights between the Contracting States. When a taxpayer of one Contracting State has a presence in the other Contracting State that reaches a certain threshold, it is fair to grant the source State (i.e. the PE State) certain taxing rights. The second function of Art. 7 should be seen from the perspective of the taxpayer. In particular, when the taxpayer's presence in the other Contracting State reaches a certain threshold, he should be treated similarly to a competitor who is a resident of the PE State, i.e. the taxpayer should be subject to the tax regime of the PE State. It would not be fair if the taxpayer would be taxed more or less favourably simply because he is not a resident of the PE State but of the other Contracting State[422]. From this perspective, there is a certain overlap between Article 7 and Article 24(3): both provisions require the PE to be treated as a separate enterprise and to be taxed accordingly by the PE State. From the perspective of Art. 7, the separate enterprise fiction is used to attribute an appropriate amount of profits to the PE. From the perspective of Art. 24(3), the PE is seen as a separate enterprise in order to compare it to a resident taxpayer[423].

As both provisions require the PE to be treated as a separate enterprise, one might argue that certain issues could be resolved both under Art. 7 and under Art. 24(3). Consider, for instance, the *Reuters*-case, discussed hereafter. In that case, the taxpayer argued that the PE non-discrimination provision was violated because his PE was taxed less favourably than a resident taxpayer. More specifically, the U.K. resident taxpayer's worldwide profit was proportionally allocated to his New York PE for tax purposes. In contrast, if the PE had been a subsidiary established in New York, there would be no apportionment of the taxpayer's worldwide income. Instead, only the subsidiary's income would be taxable in New York. The case thus gave rise to complicated issues of comparability under Art. 24(3), with the court ultimately deciding in favour of the tax authorities.

However, this is not a matter of discrimination. Rather, the issue should be resolved under Art. 7. Attribution of income to the PE is a matter of Art. 7 and, even though the PE may be treated differently from (and even less favourably than) a resident taxpayer, this has little to do with Art. 24(3). If the domestic method of attributing income to the PE is contrary to Art. 7, the case should be decided in favour of the taxpayer on that basis[424]. Conversely, if Art. 7

---

[422] See also M. LANG, "The concept of permanent establishment and its interpretation", *Rivista di Diritto Tributario Internazionale* 2002, No. 1/2002, 17.

[423] As a side-note, it could be argued that the OECD MC (particularly before the 2010 update) itself created instances of discrimination contrary to Art. 24(3) by sometimes deviating from the separate entity-approach. That is to say, if the PE is treated less favourably than a resident enterprise due to limitations on the separate entity-approach (for instance because of the non-recognition of internal dealings), it could be said that Art. 24(3) has been infringed. On the other hand, Art. 24(3) should be read in the context of the other provisions of the OECD MC, with the result that treatment which is mandated by those other provisions cannot be said to constitute discrimination (see 2.D.III.C.e). So insofar as the limitations on the separate entity-approach are the appropriate interpretation of Art. 7, there is no infringement of Art. 24(3).

[424] E.g. U.S. Tax Court 12 December 1996, *The North West Life Assurance Company of Canada v CIR*, No. 6494-94, 107 *T.C.* 363: because the application of a formulary method to attribute investment income to the PE was contrary to Art. 7, the Court held that it was unnecessary to determine whether the PE non-discrimination provision was also violated (*"Having found that petitioner is entitled to relief from section 842(b) based on*

(implicitly or expressly) mandates the domestic method of attributing income, then the Contracting States' intention to mandate a difference in treatment between PEs and resident taxpayers should be respected (which means that Art. 24(3) has not been infringed).

This shares some similarities with an argument discussed earlier, in the context of the 1972 decision of the Dutch Supreme Court (see supra, 2.B.VI.D.b). In that decision, the Court seems to suggest that distributive tax treaty provisions cannot be discriminatory. The mere division of taxing powers between Contracting States cannot give rise to discrimination; only when a State **exercises** the jurisidiction so divided in a discriminatory manner, can the non-discrimination provision come into play. That position was dismissed in 2.B.VI.D.b because it was based on an incorrect analogy with the ECJ's case law[425].

The conclusion reached here is different. I do not suggest that distributive rules, by their nature, fall outside the scope of Art. 24. Instead, issues involving the attribution of income to a PE (and, more generally, the division of taxing powers between Contracting States) should be resolved under the applicable rules of Arts. 6-21. If the domestic measure at issue is found to violate those rules, the case is decided in favour of the taxpayer without it being necessary to address Art. 24. If the domestic measure is in accordance with the distributive rules, then the Contracting States' intention to mandate differential treatment should be respected and Art. 24 should be set aside. That does not mean, however, that distributive rules, by their nature, go beyond the scope of Art. 24. It only means that Art. 24 is a provision in a bilateral treaty, and the Contracting States are free to bilaterally deviate from this provision. If they choose to do so, whether implicitly or expressly, whether in Art. 24 or elsewhere, then the scope of application of Art. 24 is restricted accordingly.

II.B. Case law

a. Case law on the subject of comparison

1. Reuters Ltd[426]

The taxpayer was a U.K. resident company with a PE in New York[427]. The taxpayer did business in 80 different countries and, during the tax years at issue, realised a profit in respect of its worldwide activities. However, during those tax years, the New York PE incurred losses. For the purposes of the New York franchise tax[428], the taxpayer only took account of the income from its U.S. operations and, therefore, paid no New York franchise tax. The U.S. tax authorities disagreed, arguing that the worldwide net income apportionment method had to be applied. Under that method, the taxpayer would be liable to New York franchise tax in

---

Article VII, paragraph 2 of the [tax treaty], we have no need to delve into the question of whether petitioner is also entitled to such relief based on Article XXV, paragraph 6").

[425] The issue in the 1972 case concerned the application of Art. 24 of one tax treaty to the provisions of another tax treaty, while the issue discussed here concerns the application of Art. 24 of a tax treaty to the provisions of the same tax treaty. However, that difference does not affect the argument at issue here.

[426] New York Supreme Court, Appellate Division, Third Department 11 June 1992, *Reuters Ltd v Tax Appeals Tribunal et al.*, 584 N.Y.S.2d 932.

[427] For the sake of clarity, I will refer to the federated states of the US, such as New York, as "US states". In contrast, I will refer to the sovereign States that have concluded the tax treaty, such as the US, as "Contracting States".

[428] Tax Law § 209(1) *"For the privilege of exercising its corporate franchise, or of doing business, or of employing capital, or of owning or leasing property in this state in a corporate or organized capacity, or of maintaining an office in this state every domestic or foreign corporation shall annually pay a franchise tax, upon the basis of its entire net income"*, which included income earned *"within and without the United States"*.

respect of its PE despite the losses incurred in the U.S., because the worldwide profit was proportionally allocated to the PE for tax purposes[429]. The taxpayer objected against this assessment, contending that the worldwide net income apportionment method was contrary to the PE non-discrimination provision of the U.K./U.S. tax treaty[430].

The Appellate Division of the New York Supreme Court decided in favour of the tax authorities, holding that domestic and foreign taxpayers were treated uniformly. The taxpayer argued that the comparison had to be made between the taxation levied on its New York PE and the taxation levied on a New York company conducting business exclusively in New York. The Court dismissed this argument, pointing out that the non-discrimination provision required a comparison *"between the taxation of [the taxpayer's New York PE] and the taxation of a United States corporation having a branch in New York and conducting international business through branch offices in other countries."* From that perspective, there was no discrimination.

The Court further noted that the non-discrimination provision was ambiguous with regard to whether the phrase 'carrying on the same activities' refers to the activities of the PE or to the corporation of which the PE is a part. The Court stresses the fact that *"the tax here is a franchise tax imposed on petitioner, the corporate entity, and that a United States corporation 'carrying on the same activities' as the petitioning corporation with a New York branch and worldwide branch activities would be subject to the very same tax as petitioner."* Moreover, the taxpayer, like a U.S. company, could have elected to do business in New York in subsidiary form rather than PE form and thus avoided the tax disadvantage[431].

The Court finally refers to the legislative history of the U.K./U.S. treaty, which *"clearly manifests an intent, at least where a single corporation is involved, to allow the states the freedom to tax branches of a United Kingdom corporation on the basis of the corporation's worldwide income as allocated to each state"*.

This decision was subsequently confirmed by the Court of Appeals of New York[432]. The taxpayer reiterated his argument that the analysis had to be made by comparing the taxation levied on its PE with the taxation levied on a hypothetical New York corporation carrying on business only in New York and conducting activities similar to those carried out by the taxpayer at its New York PE. Consequently, the PE had to be treated as a separate entity for tax purposes, discrete from the U.K. parent. Under the taxpayer's analysis, there was discrimination because a hypothetical New York company that earned no income outside New York would not be subject to the worldwide net income apportionment method.

---

[429] The apportionment formula for purposes of New York corporate franchise tax consisted of two steps. First, the *business allocation percentage* was calculated, which was ascertained by comparing the value which the corporation's real and tangible personal property within New York bears to the worldwide value of the same factors. The corporation's worldwide business income was then multiplied by the business allocation percentage to arrive at the *entire net income base*, i.e. the portion of the taxpayer's entire net income allocable to and taxable by New York. The franchise tax was computed at the rate of 9% of the taxpayer's entire net income base.

[430] Art. 24(2) of the 1975 treaty between the U.K. and the U.S., which was identical to Art. 24(4) of the 1963 OECD Draft Convention.

[431] The latter argument is not very convincing. The purpose of the PE non-discrimination clause is precisely to avoid less favourable treatment of PEs as compared to resident companies (e.g. a subsidiary of the non-resident taxpayer).

[432] Court of Appeals of New York 12 October 1993, *Reuters Ltd v Tax Appeals Tribunal et al.*, 82 N.Y.2d 112.

However, the Court of Appeals dismisses the taxpayer's analysis, holding that the PE *"is not juridically equivalent to a free-standing entity as proposed in [the taxpayer's] hypothetical analogy. [The PE] cannot be lifted out of and placed in the isolation of its own legal universe, for the tax and juridical realities under the antidiscrimination clause are otherwise. […] A branch office has no corporate or jural identity separate from the corporation of which it is a part."*

Moreover, the Court observes that the purpose of the non-discrimination clause is to protect foreign taxpayers against local economic discrimination resulting from disparate tax treatment. In the case at hand, the ultimate taxpayer was the corporate entity, i.e. the U.K. parent, not its branch affiliate. Accordingly, *"to measure the potential discriminatory effect of New York's franchise tax, by reference to [the PE] as an enterprise discrete from its juridical parent, is not supportable under the language or purpose of the nondiscrimination clause."* The Court therefore concludes that the U.K. head office and its PE *"are a single, inseparable business enterprise for franchise tax purposes."*

> Like the Appellate Division of the New York Supreme Court, the Court of Appeals finds support for its conclusion in the treaty's legislative history, particularly in the context of Art. 9 of the treaty, on associated enterprises. The original version of Art. 9(4) of the treaty (which the U.S. Senate ultimately refused to ratify) prohibited the political subdivisions and local authorities of the Contracting States (including the U.S. states) from employing the 'California-type' worldwide combined reporting methodology[433]. Under that method, an apportionment formula was applied to the combined worldwide income of related corporate affiliates and subsidiaries[434]. The legislative history of the proposed Art. 9(4) showed that the use of worldwide formulary apportionment methods *as applied to a single enterprise* would remain unaffected by the treaty. The U.S. Senate Foreign Relations Committee's Report on the treaty provided: *"if a U.S. branch of a British corporation does business in a state, that state cannot apply the unitary method to combine the income […] of any related foreign enterprises […] with those of that British corporation in determining the income of its U.S. branch which is taxable by that state.* ***However, that state may take into account the income and assets of any other branches of that corporation, wherever located, because a***

[433] The provision applied to combined reporting methods (to be contrasted with separate accounting methods, as advocated e.g. by the OECD MC). In order to determine the amount of income which a corporation earns within a U.S. state (and which is therefore subject to tax in that state), different types of apportionment methods are used. For instance, some states (e.g. New York at the time of the case at issue) use the so-called 'unitary method': business income is apportioned between the state and other jurisdictions according to a three-factor formula, under which total business income is multiplied by the average ratio of sales, payroll and property values within the state to total sales, payroll and property values associated with the business. The proposed Art. 9(4) of the treaty did not affect these methods. However, in some other U.S. states (e.g. California at the time of the case at issue), there were 'combined reporting' requirements, which extended the unitary method to companies related to the company doing business within the state (e.g. parent companies, subsidiaries, etc.) if the state considered the activities of the related company to constitute a unitary business, regardless of whether those related companies were doing business in that state. The proposed Art. 9(4) of the treaty prevented states from extending the unitary method through this combined reporting system to related foreign enterprises where the enterprise doing business in the state in question was either a U.K. enterprise or was controlled by a U.K. enterprise. However, after the U.S. Senate refused to ratify this provision, it was subsequently amended by the third protocol of 15 March 1979, which deleted the reference to "political subdivisions or local authorities" in Art. 9(4). As a result of this amendment, the limitation of Art. 9(4) only applied to the Contracting States themselves, not their subidivisions. This is the context in which the U.S. Senate Foreign Relations Committee's Report made the quoted remark as regards the functioning of Art. 9(4).

[434] For a general overview, see K. WRIGHT, *California Income Tax Manual*, Chicago, CCH, 2008, 353-414 and 437 *et seq.* See also R. DOERNBERG, "Overriding tax treaties: the U.S. perspective", *Emory International Law Review* 1995, 128-130.

> ***corporation is considered to be a single enterprise regardless of how many separate branches or businesses it has"***[435].
>
> A similar observation could be found in the U.S. Treasury Department's technical explanation of the treaty: *"Because a corporation is considered a single enterprise regardless of how many branches it has, a State may take into account the income and assets of all branches of that corporation, wherever located"*[436].
>
> From this, the Court concludes that *"the argument that the treaty drafters intended Article 24(2) as an indirect curtailment on the open and wide-spread use of worldwide income apportionment methods strains credulity and proper interpretation. Forty-one states, including New York, currently apply an apportionment formula to the worldwide net income of a single business enterprise operating multijurisdictionally. Four other states, including California, apply an apportionment formula to the combined worldwide income of related corporations operating multijurisdictionally. In fact, the treaty expressly denies the Federal Government the power to use formulary apportionment in Article 7(2) and is tellingly silent in that regard with respect to the states' long-standing power and their varied implementation."*
>
> In other words, the Contracting States did not intend that Art. 24 would limit the freedom of the U.S. states to apply their apportionment methods. The proposed version of Art. 9(4) expressly precluded the U.S. states applying the 'California-type' worldwide combined reporting methodology. Even then, however, the 'New York-type' methodology was left unaffected. Following the U.S. Senate's reservations, Art. 9(4) was ultimately amended and the reference to 'political subdivisions and local authorities' was deleted. After that amendment, Art. 9(4) no longer restricted the freedom of the U.S. states to apply their apportionment methodologies (including the 'California-type' method). From this, the Court inferred that Art. 24 could not be seen as placing any restriction on the freedom of the U.S. states to use formulary apportionment.

Put briefly, the Court refuses to construct the subject of comparison by considering the PE in isolation. Instead, the PE and the head office together – as a single, inseparable business enterprise – constitute the subject of comparison. It is essential here that, unlike the federal U.S. system, the New York tax system did not tax a PE as an entity separate from the enterprise of which it forms part[437]. Most national systems of international tax law consider the PE to be a separate entity, with its own profits and losses and its own characteristics (at least to a certain extent), and this is also the approach taken by the OECD MC. The New York system, however, did not consider the PE to be a separate entity to which profits and losses could be attributed. Rather, the franchise tax was imposed in respect of the grant of a privilege, for instance the privilege of doing business in a U.S. state, and calculated by allocating a proportionate fraction of the worldwide value of the business to the New York branch. This explains why the Court does not consider the PE in isolation, but rather as forming part of "a single, inseparable entity" with the head office.

That being said, it is unfortunate that the Court's line of reasoning is not entirely straightforward. It would have been clearer if the analysis had started with an inquiry as to whether the apportionment method was compatible with Art. 7 of the treaty. If the method is incompatible with Art. 7 of the treaty, the Court would have to decide in favour of the

---

[435] Senate Executive Report No. 95-18, 1980-81 *C.B.* 411, 420 (emphasis added by the Court).
[436] 1980-81 *C.B.* 455, 462.
[437] P. KAPLAN, "Reuters Ltd v Tax Appeals Tribunal: tax planning opportunity for banks and other companies with branches in the United States of America", *B.T.R.* 1992, 286.

taxpayer without it being necessary to carry out a discrimination-analysis[438]. Conversely, if Art. 7 of the treaty expressly allows the use of an apportionment method, in line with Art. 7(4) OECD MC, then it is clear that the Contracting States wanted to deviate from Art. 24(3) in this respect[439].

In the present case, there was no provision in the treaty analogous to Art. 7(4) OECD MC. However, the Court inferred from the treaty's legislative history that the Contracting States did not intend the PE non-discrimination clause as a curtailment of the *"open and widespread use of worldwide income apportionment methods"*. That should have been sufficient. As it was the treaty partners' intention to set aside Art. 24, there could be no further discrimination-issue.

Apparently, the Court sees the intention of the Contracting States, as revealed by the treaty's legislative history, as supporting the conclusion reached earlier, that the apportionment method does not violate Art. 24[440]. However, that is not entirely convincing. Either the Contracting States intended to deviate from Art. 24 – in which case Art. 24 finds no application – or they did not intend to deviate from Art. 24, in which case Art. 24 fully applies. In the present case, the amendment made after the U.S. Senate's reservation makes it clear that the Contracting States did not intend to limit the freedom of the U.S. states to apply their apportionment methods. Art. 24 cannot be invoked to set aside this clear intention of the Contracting States.

This case illustrates the entanglement of Art. 24(3) with the separate entity approach underlying Art. 7 (see supra). The disadvantage at issue was that the PE was not taxed as a separate entity. Instead, a portion of the worldwide profits was attributed to the PE. This is a matter that should be resolved under Art. 7. If Art. 7 allows the application of such apportionment methods, then Art. 24 is set aside by the Contracting States' intention. As a result, Art. 24 has no role to play in these issues. The Court's disregard for the influence of Art. 7 on Art. 24(3) thus explains its remarkable line of reasoning with respect to the subject of comparison.

As a final remark, it should be noted that the Court does not only disagree with the **subject** of comparison proposed in the taxpayer's analysis, but also with the **object** of comparison in that analysis (i.e. a New York corporation carrying on business solely in New York). Once again, this can be explained by the particular nature of the New York tax at issue. Referring to the treaty definitions of 'enterprise'[441] and 'resident', the Court held that the appropriate object of comparison was an industrial or commercial undertaking carried on by a U.S. corporation. When the commercial undertaking was the branch office of a U.S. corporation, *"the branch and the corporation are a single business enterprise for franchise tax purposes."*

---

[438] E.g. U.S. Tax Court 12 December 1996, *The North West Life Assurance Company of Canada v CIR*, No. 6494-94, 107 *T.C.* 363: because the application of a formulary method to attribute investment income to the PE was contrary to Art. 7, the Court held that it was unnecessary to determine whether the PE non-discrimination provision was also violated (*"Having found that petitioner is entitled to relief from section 842(b) based on Article VII, paragraph 2 of the [tax treaty], we have no need to delve into the question of whether petitioner is also entitled to such relief based on Article XXV, paragraph 6"*).

[439] See also 2.D.III.C.e.

[440] The question whether, and to what extent, the legislative history of the treaty can be relied on to reveal the Contracting States' intention will not be addressed here.

[441] Which was defined in Art. 3(1)(d) of the treaty as *"an industrial or commercial undertaking carried on by a resident of a Contracting State"*.

The Court thus makes the comparison between the taxation of the New York PE and the taxation of a U.S. corporation with a branch in New York and conducting international business through branch offices in other countries. On the basis of this comparison, the Court holds that the PE was not treated less favourably than the object of comparison, meaning that there was no discrimination.

2. Brussels Court of Appeal 28 May 1993[442]

The taxpayer was a Swiss insurance company with a PE in Belgium, through which it held a number of shares in Belgian companies and received dividends in respect of those shares. Under Belgian domestic tax law, Belgian resident companies that paid dividends to their shareholders were required to withhold tax at source on these payments.

In order to mitigate double economic taxation, the Belgian participation exemption regime provided that 95% of dividends received by a Belgian shareholder from a Belgian company were exempt from income tax, provided that certain conditions were met. Under the Belgian non-residents' income tax, the Belgian PE of the taxpayer was entitled to this regime. However, the Belgian PE of a non-resident taxpayer receiving dividends exempt under the participation exemption regime could not set off the tax withheld at the level of the company distributing the dividends against their non-residents' income tax due[443]. In contrast, Belgian resident companies that enjoyed the benefits of the participation exemption regime were entitled to set off the tax withheld by the distributing company against their own corporate income tax. The taxpayer argued that this distinction was contrary to the PE non-discrimination provision of the Belgian/Swiss tax treaty[444]: the PE was treated less favourably than a Belgian insurance company, as the latter would have been able to credit the tax withheld at source[445].

The Belgian tax authorities first argued that for non-residents with a PE in Belgium, the withholding tax at the level of the distributing company was the only tax to which the dividends were subject in Belgium, whereas for residents such dividends were taxed a second time in Belgium when they were redistributed or when the company receiving them was liquidated. Accordingly, the benefit for the resident shareholders, i.e. that they were able to offset the tax withheld at source, was only of a temporary nature, as they would eventually be taxed upon redistribution of the dividends or upon liquidation. In other words, the impossibility for non-residents to credit the withholding tax was explained by contending that it served to counterbalance a disadvantage encountered by residents (i.e. the subsequent taxation)[446].

[442] *A.F.T.* 1993, 287-291, confirmed by the Supreme Court on 26 January 1995, No. AR F.93.115.F, *F.J.F.* 1995, 105. The Court of Appeal later took the same approach in an identical case (concerning the treaty with the Netherlands) of 17 June 1993, *Fisc. Koer.* 1993, 647. The latter case was subsequently confirmed by Supreme Court, 23 March 1995, *F.J.F.* 1995, 277. See also P. KERFS, "Taxation of permanent establishments in conflict with non-discrimination provisions in tax treaties", *European Taxation* 1994, 114-116.
[443] At the relevant time, this rule was laid down in Art. 192 ITC.
[444] Art. 25(3) of the 1978 treaty, identical to Art. 24(3) of the 1977 OECD MC.
[445] The possibility that this Belgian regime may be discriminatory has long been recognized in Belgian legal doctrine. See for instance P. GLINEUR, "Le régime des revenus définitivement taxés dans le chef des sociétés non-résidentes – Persistance de dispositions discriminatoires dans le cadre des conventions internationales préventives de la double imposition", *R.G.F.* 1983, 5, 129-145. The discriminatory provision (at that time renumbered as Art. 283) has been removed from the Income Tax Code by the Law of 30 January 1996, *Official Gazette* 30 March 1996.
[446] The idea that a disadvantage incurred by the subject of comparison does not entail discrimination because it counterbalances a certain advantage granted to the subject of comparison (in the present case, the advantage at

Unsurprisingly, the Court dismissed this argument. The Court pointed out that the taxes withheld upon redistribution of the dividends or upon liquidation of the company were not taxes on account of the company, but on account of the ultimate recipients of that payment (i.e. the shareholders of the company). The Court moreover observes that this argument would entail that Art. 24(3) would be devoid of any meaning: if it were accepted, the absence of certain Belgian taxes in the case of a non-resident's PE – an absence which is due to the very nature of the concept of a PE – would justify every conceivable difference in treatment.

In other words, the mere fact that a PE is not subject to taxes in Belgium when it 'repatriates' profits to its head office, does not mean that it is incomparable to a Belgian resident company, which is subject to taxes when it distributes profits to its parent company. This difference is inherent in the very nature of the PE, and cannot be relied on to exclude the PE from benefits granted to resident companies. As mentioned earlier, the starting point in constructing the subject of comparison should be an isolationist approach: the PE should be considered as a separate entity, without taking account of the tax position of its head office. This explains why the absence of taxation upon repatriation of the profits to the head office plays no role in the comparability test. Only where the tax position of the head office (or, in the present case, the tax treatment of dealings between the PE and the head office) is relevant for the tax position of the PE, should it be taken into consideration in the comparability-test.

As a second argument, the tax authorities referred to the judgment of the Supreme Court of 30 June 1988, concerning the compatibility of the Belgian regime with Art. 25 and 17(3) of the Belgian/French treaty. As discussed in 2.B.V.B.d, the Supreme Court decided in that case that Art. 25 of the applicable treaty had not been violated because the taxpayer, a French company, was not in the same circumstances as a Belgian company: Belgian companies were liable to corporate income tax, whereas the French company was liable to the non-residents' income tax. In the present case, the tax authorities argued that the phrase 'in the same circumstances' was used both in Art. 25 of the treaty with France (at issue in the 1988 case) and in Art. 25(1) of the treaty with Switzerland[447] (the nationality non-discrimination clause of the treaty at issue in the present case). On that basis, the administration contended that Belgium was only required to grant a Swiss resident company the same treatment as a Belgian resident company, insofar as the Swiss company is, like the Belgian company, subject to the Belgian corporate income tax. In other words, two companies, one of which is subject to the Belgian corporate income tax and one of which to the Belgian non-residents' income tax, are not in the same circumstances. As a result, the latter company is not entitled to be treated identically to the former company[448].

---

issue is the absence of the subsequent taxation upon redistribution or liquidation) is an aspect of the disadvantage-test; see 2.D.III.B. As will be pointed out below, this argument can also be expressed as a matter of comparability. From that perspective, the argument would be that, because a PE is not subject to taxes in Belgium when it repatriates profits to its head office, it is not comparable to a Belgian resident company, which is subject to taxes when it distributes profits to its parent company. The Court of Appeal dismisses this argument, because the absence of taxation upon the repatriation of profits is inherent in the very notion of the PE and would therefore imply that Art. 24(3) is devoid of any meaning.

[447] Identical to Art. 24(1) of the 1977 OECD MC.

[448] *"Dat volgens de Administratie de zinsnede 'die onder gelijke omstandigheden zijn of kunnen worden onderworpen' […] er ondubbelzinnig op wijst dat België slechts gehouden is een Zwitserse vennootschap op dezelfde wijze te behandelen als een vennootschap die een Belgische verblijfhouder is, voor zover de Zwitserse vennootschap, net als de Belgische vennootschap, onderworpen is aan de vennootschapsbelasting en dat, met andere woorden, twee rechtspersonen, waarvan de ene aan de vennootschapsbelasting en de andere aan de belasting der niet-verblijfhouders onderworpen is, zich niet in dezelfde omstandigheden bevinden, zodat de*

The Court dismissed this argument as well. Unlike the Belgian/French treaty at issue in the 1988 case, the 1978 Belgian/Swiss treaty contained a PE non-discrimination clause in line with Art. 24(3) OECD MC. Accordingly, it was prohibited under the latter provision to treat a PE of a non-resident taxpayer less favourably than a resident enterprise carrying on the same activities. As a result, the applicability of different taxes to subject and object of comparison was irrelevant for purposes of that provision: the PE of a Swiss company, which is, by definition, subject to the non-residents' income tax, is compared to a Belgian resident company, which is subject to the corporate income tax. The tax administration's interpretation would deprive Art. 24(3) of any meaning, as it would mean that the comparison has to be made between a PE, subject to the non-residents' income tax, and a Belgian resident company that is also subject to the non-residents' income tax. This comparison is impossible to carry out (because Belgian residents are never subject to the non-residents' income tax), which would mean that Art. 24(3) would be devoid of any meaning.

Thirdly, the tax authorities argued that Article 10(4) of the treaty[449] entitled Belgium to tax dividends received by a Belgian PE without any limitations. The Court dismissed this argument as well, pointing out that this provision did not allow Belgium to tax those dividends without taking account of the obligations imposed by the PE non-discrimination clause of the treaty.

Finally, the tax authorities referred to the OECD Commentary, which states that opinions differ as to whether the PE of a non-resident taxpayer should be entitled to domestic measures regarding the taxation of dividends distributed between companies[450]. In this respect, the Court of Appeal refers to the observation in the Commentary that it is difficult to reconcile the levy of a withholding tax exclusively on income paid to non-resident taxpayers with the obligation laid down in Art. 24(3)[451]. According to the Court, the Belgian measure (which restricted the possibility to credit the tax withheld at source to resident taxpayers) had the same effect as the levy of a withholding tax exclusively on payments to non-residents. Art. 25(3) of the treaty did not contain an exception to the general rule that a PE of a non-resident taxpayer should not be treated less favourably than a resident company carrying on the same activities[452]. In the absence of such an exception, the general rule of Art. 25(3) should prevail. As a result, the Court decided that the Belgian measure was discriminatory because it treated the PE of a non-resident taxpayer less favourably than a resident enterprise carrying on the same activities.

---

tweede vennootschap zich niet kan beroepen op de Overeenkomst om aanspraak te maken op een gelijke behandeling als de eerste."

[449] *"The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply"* (i.e. substantially identical to Art. 10(4) OECD MC).

[450] See Comm. OECD on Art. 24, para. 48-50. This section of the Commentary is discussed in 2.D.III.B.c.

[451] See Comm. OECD on Art. 24, para. 64-65.

[452] As an example, the Court refers to the 1967 treaty between Belgium and Germany, which provides for such an exception in point 15(2) of the Protocol: *"The provisions of [Article 24] shall not be construed as obliging a Contracting State to apply the same provisions under its national law with respect to taxation of dividends derived by a company resident of that state also to the dividends derived by a permanent establishment operated by a company which is a resident of the other State."*

3. Ghent Court of Appeal 17 November 1994[453]

The same Belgian legislation was at issue in this 1994 case, concerning the Belgian PE of a U.K. resident company[454]. Once again, the Belgian tax authorities argued that Art. 24(1) of the treaty required the non-resident to be 'in the same circumstances' in order to be entitled to non-discriminatory treatment. Since the taxpayer was subject to the non-residents' income tax, and not the corporate income tax, it was not in the same circumstances as a Belgian resident company.

The Court dismissed this argument, pointing out that the situation at issue was not governed by Art. 24(1) of the treaty but by the more specific Art. 24(3). Under the latter provision, the tax administration's argument was irrelevant. According to the Court, the fact that the taxpayer was subject to the non-residents' income tax, while Belgian companies were subject to the Belgian corporate income tax *"did not change the comparability of their factual tax position."* Consequently, the difference as regards the tax to which they were liable could not explain the less favourable treatment of a non-resident's PE as compared to a Belgian company.

---

453 *A.F.T.* 1995, 135-138.

454 Art. XXIV of the 1967 Belgian/U.K. treaty was, for purposes of the present discussion, identical to Art. 24 of the 1963 OECD Draft Convention. It should be noted that the PE non-discrimination provision of the **1987** Belgian/U.K. treaty, which was not yet applicable to the facts of the present case, contains a specific clause concerning the Belgian withholding tax on dividends. Article 24(3)(b) of that treaty provides: *"Nothing in this Article shall be construed as preventing Belgium from imposing the movable property prepayment on dividends derived from a holding which is effectively connected with a permanent establishment […] maintained in Belgium by a company which is a resident of the United Kingdom […]."* This clause thus entitles Belgium to levy withholding taxes on dividends paid to a Belgian PE of a U.K. resident company. As such, this provision seems redundant, since the possibility to withhold source tax on such payments is already guaranteed by Art. 10(5) of the treaty (identical to Art. 10(4) OECD MC). As mentioned earlier, the OECD Commentary states that Article 24(3) precludes a State from levying withholding taxes exclusively on payments made to the PE of non-resident taxpayers. In the case of 28 May 1993 (see supra), the Brussels Court of Appeal correctly decided in this respect that Article 10(4) does not mean that the source State of the dividends is free to tax dividends received by a non-resident's PE without any limitations: Article 10(4) is subject to the restrictions imposed by Article 24(3), with the result that the source State cannot levy a withholding tax exclusively on payments made to non-residents. Insofar as Belgium levies a withholding tax both on dividends paid to residents and on dividends paid to the PE of a non-resident, Art. 24(3)(b) of the Belgian/U.K. treaty is therefore redundant (see infra 2.D.III.B.d; see also J. GHYSBRECHT, "Commentaire de la convention préventive de double imposition entre la Belgique et le Royaume-Uni de 1 Juin 1987", *J.D.F.* 1990, 205-206). As the clause only refers to *"imposing the movable property prepayment"*, it is unlikely that it also covers the possibility to **credit** the tax so withheld, which was at issue in the present case. In other words, it seems unlikely that Art. 24(3)(b) of the 1987 treaty could be relied on in order to deny a non-resident's PE the possibility to credit tax withheld at source, while residents are entitled to such credit (see also A. BAX, "Het beginsel van gelijke behandeling van Belgische vaste inrichtingen in het kader van de Belgische dubbelbelastingovereenkomsten", *A.F.T.* 1991, 189). Compare this, for instance, to the 1970 Belgian/U.S. treaty, as amended by the 1987 protocol. Art. 10(6) of that treaty supplements Art. 10(4) as follows: *"For the purpose of paragraph 4 and notwithstanding any other provision of the Convention, dividends paid by a company which is a resident of Belgium in respect of a holding which forms part of the assets of a permanent establishment situated in Belgium, may be taxed separately in accordance with Belgian law."* This provision expressly supersedes the non-discrimination provision, and allows Belgium to deny the credit to the PE of a U.S. taxpayer. See, in this respect, the Explanatory Memorandum to the Protocol, *Gedr. St.* Kamer, 1988-89, 13 January 1989, No. 674/1, 3, which confirms that Art. 10(6) allows Belgium to deny the credit to such PEs (*"Op te merken valt evenwel dat Artikel 10 in zijn paragraaf 6 een bepaling bevat die uitdrukkelijk het recht van België bevestigt artikel 192 [WIB] toe te passen zodat de roerende voorheffing op dividenden van vaste deelnemingen aangehouden door een in België gevestigde vaste inrichting van een vennootschap, die inwoner is van de Verenigde Staten, niet met de door die vennootschap definitief verschuldigde belasting wordt verrekend."*)

Secondly, the tax authorities argued that the PE was not allowed to credit the tax withheld at source because it was not possible to apply Belgian withholding taxes when the profits were subsequently redistributed to the shareholders of the U.K. company, as that redistribution took place abroad. The Court pointed out that this argument confused the taxation of the Belgian PE in respect of the dividends received from a Belgian company with the taxation of the shareholders of the U.K. company in respect of the profits redistributed by the Belgian PE. The credit for tax withheld at source, which the taxpayer claimed, related to dividends paid by the Belgian company to the Belgian PE. Consequently, the impossibility to credit this tax could not be explained by the fact that Belgium was unable to levy withholding taxes on the dividends distributed by the U.K. company to its shareholders. Indeed, the additional taxation to which the administration referred, i.e. the taxation upon redistribution, concerned the taxation in the hands of a different entity, namely the shareholders of the U.K. company and not the Belgian PE. The Court therefore dismissed the tax administration's argument and held that the Belgian measure fell foul of Art. 24(3) of the treaty.

Once again, the Court thus decides that the subject of comparison should be constructed as a separate entity, independent of its head office. The absence of Belgian taxation when a PE 'distributes' profits to its head office, does not mean that it is incomparable to a Belgian resident company, which is subject to withholding taxes in Belgium when it distributes dividends to its parent company. This difference is inherent in the very nature of the PE, and cannot be relied on to exclude the PE from benefits granted to resident companies. In principle, the taxation (or, rather, the absence thereof) on dealings between PE and head office should therefore not be taken into account when constructing the subject of comparison.

4. Bundesfinanzhof 22 April 1998[455]

A Philippine corporation that operated aircraft in international traffic had a PE in Germany. Under German domestic tax law, the profits of a non-resident airline were deemed to be 5% of the income derived from transport within Germany or from Germany to other countries. Under this regime, it was impossible for a non-resident airline to deduct or carry over losses. Pursuant to the 1983 German/Philippine treaty, profits from the operation of ships or aircraft in international traffic derived by an enterprise of a Contracting State could be taxed in that State[456]. However, the treaty also provided that the source State could tax those profits as well, but the tax so charged could not exceed 1.5% of the gross revenue derived from sources within that State[457]. Applying these provisions, the German tax authorities assessed the PE of the Philippine airline to German tax on a taxable basis of 1.5% of its gross revenue from German sources. The taxpayer appealed against this assessment, arguing that it was contrary to the PE non-discrimination provision of the German/Philippine treaty because German resident airlines were able to deduct or carry forward losses.

The Bundesfinanzhof decided in favour of the taxpayer. The Court first noted that 'other' taxation was not necessarily contrary to the PE non-discrimination clause, as long as it was not 'less favourable'. According to the Court, the comparison had to be made on an 'overall'

[455] No. I R 54/96, *BFHE* 186, 89.
[456] Art. 8(1) of the treaty, similar to Art. 8(1) OECD MC.
[457] Or, alternatively, the lowest rate of Philippine tax applied on such profits derived by an enterprise of a third State (depending on which was lower); see Art. 8(2) of the treaty. The OECD MC does not contain a similar provision.

basis, i.e. taking account of the PE's total tax burden[458]. As resident airlines were able to deduct losses, the treatment of the PE of the Philippine airline was less favourable in the present case[459]. According to the Court, it was irrelevant in this context that the PE losses could possibly be taken into account in the Philippines[460]. In other words, when constructing the subject of comparison, the PE has to be considered in isolation, without interference from the head office's tax position. In the present case, the possibility for the head office to take the losses into account did not affect the comparability of the PE with a resident enterprise.

5. Bundesfinanzhof 10 March 2005[461]

The taxpayer was a U.S. company with a PE in Germany, through which it held participations of more than 10% in several German companies. Under the participation exemption regime provided for in German domestic tax law, dividend income received from shareholdings of more than 10% in German companies was exempt from tax in Germany if certain conditions were met. The German PE met all of these conditions, apart for one, namely that the recipient of the dividends had to be a German resident. As a result, the PE was not entitled to the benefits of the German regime. According to the taxpayer, this denial infringed the PE non-discrimination clause of the German/U.S. treaty[462].

The German tax authorities argued that the purpose of the German participation exemption regime was to prevent multiple taxation of the same income in the hands of different taxpayers. For instance, if the shares in a German resident company were held by a German holding company, the shares of which were, in turn, held by German resident taxpayers (who were subject to net wealth tax on the value of their shares in the holding company), the same income could be subject to triple taxation in Germany. In order to avoid this cumulation of tax

[458] *"Dabei ist der Vergleich der Steuerbelastungen nach überwiegender Meinung auf einer 'overall'-Basis durchzuführen, d.h. die Gesamtsteuerbelastung der Betriebsstätte ist unter Einbeziehung aller Steuern mit einem inländischen Unternehmen gleicher Tätigkeit – möglicherweise auch während eines über ein Jahr hinausgehenden Zeitraums – zu vergleichen"* (referring to Art. 24(6) OECD MC).

[459] As to the fact that Art. 8(2) of the treaty allowed the source State to tax on a gross basis, the Court holds that this is irrelevant to the existence of the discrimination: loss-making resident airlines were able to deduct or carry forward their losses, whereas non-resident airlines were taxed on a (deemed) gross-basis, albeit limited to 1.5% under the treaty. Accordingly, German domestic tax law treated the latter category of taxpayers less favourably. Moreover, Art. 8(2) did not imply that the treaty allowed Germany to restrict the deductibility of losses to German residents. Art. 8(2) only defined a maximum amount which the source State had to observe when imposing taxes on such profits. The fact that Art. 8(2) referred to gross revenue in the source State, and not to the profits of the PE, did not change anything to this conclusion. Art. 8(2) did not create a tax on gross revenue; it only imposed a limit which source States had to adhere to when imposing such a gross revenue tax: *"Gleichwohl bedeutet dies alles nicht, daß das Abkommen solche Pauschbesteuerungen bis zur vorgesehenen Höchstgrenze mit Vorrang vor dem Diskriminierungsverbot für zulässig erklären wollte. Dagegen spricht, daß Art. 8 Abs. 2 DBA-Philippinen nur eine Besteuerungs-Höchstgrenze enthält. […] Der Umstand, daß der abkommensrechtlich festgelegte Steuersatz von 1,5 v.H. sich nicht auf den Betriebsstättengewinn […], sondern auf die Bruttoeinnahmen aus den Quellen im Tätigkeitsstaat bezieht, ändert daran nichts. Die für eine Besteuerungsbegrenzung bestimmte Bemessungsgrundlage muß nicht mit der für die Besteuerung bestimmten Bemessungsgrundlage übereinstimmen. […] Die Regelung in Art. 8 Abs. 2 Buchst. a DBA-Philippinen schafft insoweit keinen eigenständigen Pauschalsteuertatbestand. Sie setzt einen solchen Tatbestand nicht einmal nach innerstaatlichem Recht voraus. Vielmehr trifft sie überhaupt keine Aussage über die Art der steuerlichen Gewinnermittlung, sondern begrenzt die Besteuerung lediglich der Höhe nach."*

[460] *"Es mag auch die Annahme des FG richtig sein, daß nach den Regelungen in Art. 8 DBA-Philippinen die Besteuerung der Tätigkeit, mit der die Betriebsstätte oder Niederlassung im anderen Vertragsstaat zum Gesamtergebnis des Unternehmens beiträgt, dem innerstaatlichen Recht des anderen Vertragsstaates überlassen bleiben soll."*

[461] *GmbHR* 2005, 1151-1154.

[462] Art. 24(2) of the 1989 treaty, which is identical to Art. 24(3) of the 1977 OECD MC.

burdens, the regime exempted the income in the hands of the shareholder. As the non-resident taxpayer was not liable to such a cumulative tax burden in Germany, it was not discriminatory to exclude him from the regime, since he was not comparable to a German resident taxpayer.

The Bundesfinanzhof first observed that the prohibition of discrimination laid down in the tax treaty was absolute. As a result, it was impossible for the State in question to justify an infringement. The Court then noted that the PE non-discrimination clause not only requires the subject and object of comparison to carry out the same activities, but also that both are in the same circumstances. Unlike the nationality non-discrimination clause of Art. 24(1), this was not expressly mentioned in the PE non-discrimination clause, but this requirement arose from the general principle that non-discriminatory treatment treatment could only be claimed where the circumstances were the same, and from the relationship between both clauses[463].

Whether the circumstances were the same had to be determined by examining the characteristics of the taxable event in question. However, a purpose underlying the legal provision in question, but not expressed in the text of that provision, could not justify an infringement of the non-discrimination provision[464]. In the present case, the purpose of avoiding the cumulation of German tax burdens could not justify the exclusion of the PE from the benefit of the regime[465]. As a result, the PE has to be considered in isolation, without taking account of the taxation (or the absence thereof) at the level of the head office.

In this respect, the tax administration referred to the Bundesfinanzhof's 1998 decision concerning the German/Philippine treaty (see supra), in which the Court had held that the comparison under Art. 24(3) should be made on an 'overall' basis, i.e. taking account of the overall taxation of the PE. However, the Court dismisses this argument, pointing out that the observation made in its earlier judgment only referred to the total tax burden **of the PE** (i.e. including all types of taxation), not the tax burden of the (shareholders of the) head office[466]. Consequently, the head office's tax position should not be included in the comparison. The subject of comparison should therefore be constructed without taking account of the subsequent (non-)taxation of the income at the level of the head office.

> A similar case was decided by the Conseil d'Etat in 1985[467]. Under the French participation exemption regime, net income from participations received by taxpayers qualifying as

[463] *"Das Diskriminierungsverbot setzt allerdings über den Wortlaut des Art. 24 Abs. 2 Satz 1 DBA-USA 1989 hinaus voraus, dass die inländische Betriebsstätte eines im anderen Vertragsstaat ansässigen Unternehmens nicht nur die gleiche Tätigkeit ausübt wie das zum Vergleich herangezogene inländische Unternehmen, sondern dass auch im Übrigen gleiche Verhältnisse vorliegen. [...] Das Erfordernis gleicher Verhältnisse ergibt sich aber aus dem allgemeinen Grundsatz, dass Gleichbehandlung nur bei gleichen Verhältnissen gefordert werden kann, sowie aus dem sachlichen Zusammenhang von Art. 24 Abs. 1 und Abs. 2 DBA-USA 1989."*

[464] *"Ob gleiche Verhältnisse in diesem Sinn vorliegen, ist bezogen auf die Merkmale des jeweiligen gesetzlichen Steuertatbestands zu prüfen. Ein Zweck, der einer Vorschrift zwar zugrunde liegt, aber im Wortlaut und Sinnzusammenhang der Vorschrift keinen Ausdruck gefunden hat und deshalb innerstaatlich bei der Auslegung nicht zu Lasten der Steuerpflichtigen berücksichtigt werden kann, rechtfertigt auch im Rahmen des Art. 24 Abs. 2 Satz 1 DBA-USA 1989 keine ungünstigere Besteuerung der inländischen Betriebsstätte eines US-amerikanischen Unternehmens."* Apparently, the Court suggests that the situation would be different if the purpose of the measure was expressed in the wording of the provision. Arguably, that does not change the principle that, in general, discrimination under Art. 24 cannot be justified on the basis of the purpose of the measure at issue.

[465] The Court moreover notes that the tax administration's argument is not entirely consistent, as the regime is also applicable in several cases where there is no taxation at the shareholder level.

[466] *"Der BFH hat dabei nur die Gesamtsteuerbelastung der Betriebsstätte angesprochen, nicht aber auch die Steuerlast der Anteilseigner des betroffenen Unternehmens mit in den Vergleich einbezogen."*

[467] Conseil d'Etat 18 November 1985, No. 50643, 38 *D.F.* 9 (1986) 275 and discussed in *European Taxation* 1986, 157-159. As a response to this judgment, the French tax administration has issued a ruling describing in

'parent companies' was exempt from tax. A taxpayer qualified as a parent company under French domestic tax law, inter alia, if it was a French resident company and it held at least 10% in the capital of the distributing company. The taxpayer was an Italian resident company that held a participation of more than 10% in a French company through its French PE. As the PE was not a French resident company, it was denied the benefit of the participation exemption regime. The Conseil d'Etat decided that this was contrary to the PE non-discrimination clause of the 1958 French/Italian treaty (identical to Art. 24(4) of the 1963 OECD Draft Convention)[468].

Unfortunately, the Conseil d'Etat does not expressly address the importance of the head office's tax position. However, as the purpose of the French regime was the same as that of the German regime, this case could be considered to implicitly support the conclusion reached by the Bundesfinanzhof: the tax position of the head office should be disregarded when constructing the subject of comparison, even where the measure at issue is intended to alleviate cumulative tax burdens on profit distributions between resident companies.

6. Verwaltungsgerichtshof 16 February 2006 and 28 November 2007[469]

The taxpayer, a company resident in the Netherlands, had a PE in Austria. In 1999, the taxpayer's PE suffered a loss. In 2000, the PE made a profit. The taxpayer requested the Austrian tax authorities to deduct the loss suffered in 1999 from the profit made in 2000. Under Austrian domestic tax law, losses incurred by a non-resident taxpayer in Austria could be carried forward insofar as they exceeded the taxpayer's worldwide income that was not subject to tax in Austria[470]. Consequently, the loss carry-forward was only available to a non-resident taxpayer insofar as the Austrian losses could not be absorbed by the foreign head office. The purpose of that restriction was to avoid double loss deduction.

The Austrian tax authorities denied the taxpayer's request because the PE loss had already been taken into account in the Netherlands in 1999 for purposes of the taxation of the head office. According to the tax authorities, the loss could not be used twice (i.e. both in the Netherlands and in Austria). The taxpayer argued that this denial was contrary to the PE non-discrimination provision of the Austrian/Dutch treaty[471] because an Austrian resident taxpayer would have been able to carry over the loss.

---

which situations the benefits of the French regime are extended to a non-resident taxpayer's PE (see D. VAN WAARDENBURG, "French permanent establishments of foreign corporations receive better tax treatment", *European Taxation* 1987, 43-49). See also the ECJ's judgment in *Avoir fiscal*, discussed in Part III, 2.E.I.A.a.1.a.

[468] *"Il ressort clairement des stipulations précitées de la Convention que la succursale en France d'une société Italienne, si elle présente, comme en l'espece, le caractère d'un établissement stable au sens de ladite Convention, doit, alors même qu'elle n'a pas de personnalité juridique propre au regard du droit interne français, bénéficier d'un régime fiscal qui ne soit pas moins favorable que celui dont bénéficierait une société française; que, par suite, la succursale en France de la société 'Assicurazione Generali' […] était fondée […] à reclamer le bénéfice du régime fiscal des sociétés-mères prévu aux Articles 145 et 216 du Code Général des Impôts."*

[469] No. 2005/14/0036 and No. 2007/14/0048, respectively. Both judgments can be found in the IBFD Tax Treaty Case Law Database.

[470] § 102 Abs. 2 Z. 2 EStG 1988: *"Sonderausgaben (§ 18) sind abzugsfähig, wenn sie sich auf das Inland beziehen. Soweit Sonderausgaben bereits nach § 70 Abs. 2 und 3 berücksichtigt wurden und ein Antrag im Sinne des Abs. 1 Z. 3 gestellt wird, sind sie bei der Veranlagung anzusetzen. Der Verlustabzug (§ 18 Abs. 6 und 7) steht nur für Verluste zu, die in inländischen Betriebsstätten entstanden sind, die der Erzielung von Einkünften im Sinn von § 2 Abs. 3 Z. 1 bis 3 dienen. Er kann nur insoweit berücksichtigt werden, als er die nicht der beschränkten Steuerpflicht unterliegenden Einkünfte überstiegen hat."*

[471] Art. 25(3) of the 1970 treaty, identical to Art. 24(4) of the 1963 OECD Draft Convention.

The Verwaltungsgerichtshof decided in favour of the taxpayer. The Court first noted that in 2000, when the Austrian PE made a profit, the relief available under Dutch law for those profits was reduced by the loss of the foregoing year. Since the benefit of the deduction in the Netherlands in 1999 was thereby neutralised, the losses could not be used twice[472]. As a result, the Court held that the non-deductibility in Austria constituted discrimination contrary to the PE non-discrimination clause. As it would be possible for a resident enterprise to deduct the loss, the Court decided that the PE should be entitled to the same treatment.

Interestingly, the Court then refers to the *Marks & Spencer*-judgment of the ECJ[473], where it was held that the possibility that losses could be used twice might serve as a valid justification ground. In the present case, however, the Court observes that there was no risk that the losses would be used twice[474].

The Court subsequently notes that, from the perspective of the Netherlands, the treaty applied the credit method. In principle, the losses of a foreign PE were taken into account in the State of residence (i.e. the Netherlands) in the year in which they arose. If the foreign PE generated a profit in a subsequent year and the taxable basis was decreased in the PE-State as a result of the loss carry-forward applied in that State, then the State of residence granted a credit not exceeding the amount of tax so decreased, while taking into account the whole of the foreign PE's profits for tax purposes. Consequently, this system guaranteed that the losses were only taken into account once (on the condition that the residence State effectively taxed the PE-profits without reducing them by the loss carry-forward granted in the PE-State)[475]. In such a case, where the double use of losses was avoided, the PE non-discrimination provision of the treaty required Austria to apply the loss carry-forward[476].

---

472 *"Im Jahr 2000 sei aber in den Niederlanden der in Rede stehende Verlustausgleich wegen des Gewinnes der österreichischen Betriebsstätte im Ergebnis wieder rückgängig gemacht worden. Der Gewinn der österreichischen Betriebsstätten des Jahres 2000 werde nämlich von den Niederlanden - um eine Doppelverwertung des Verlustes hintanzuhalten - im Sinne des Befreiungsabkommens lediglich in der Höhe akzeptiert, soweit diese Einkünfte die 1999 in den Niederlanden in Abzug gebrachten Verluste übersteigen. Der Verlustausgleich werde damit 'egalisiert'."*

473 C-446/03, 13 December 2005; see Part III, 2.E.I.A.b.4.d.

474 *"Die belangte Behörde zeigt zutreffend auf, dass im Ergebnis nicht eine mehrfache Verlustverwertung eintreten darf (vgl [...] EuGH vom 13. Dezember 2005, C-446/03, Marks & Spencer [...]). Eine mehrfache Verwertung desselben Verlustes stellte eine Wettbewerbsverzerrung dar. Im gegenständlichen Fall hat allerdings die Beschwerdeführerin im Verwaltungsverfahren eingewendet, dass eine doppelte Verlustverwertung ausgeschlossen sei."*

475 *"Aus der Sicht der Niederlande folgt das DBA der Anrechnungsmethode. Dabei wird ein ausländischer Betriebsstättenverlust grundsätzlich im Verlustentstehungsjahr vom Ansässigkeitsstaat berücksichtigt. Erwirtschaftet die ausländische Betriebsstätte in einem Folgejahr einen Gewinn und wird die Steuerleistung im Betriebsstättenstaat durch den dort gewährten Verlustvortrag gemindert, rechnet der Ansässigkeitsstaat (gemäß Art. 24 Abs. 2 DBA) höchstens diesen geminderten Steuerbetrag an, wiewohl er den ausländischen Betriebsstättengewinn zur Gänze steuerlich erfasst. Im Ergebnis stellt dieses System die bloß einfache Verlustverwertung sicher. Dies hat allerdings zur Voraussetzung, dass der Ansässigkeitsstaat den nicht um einen im Betriebsstättenstaat gewährten Verlustvortrag gekürzten Betriebsstättengewinn tatsächlich in die Besteuerung einbezieht."*

476 *"In einem solchen Fall, wenn also eine doppelte Verlustverwertung, die durch eine zusätzliche Verwertung auch im Ansässigkeitsstaat entstehen würde, im Ergebnis vermieden wird, gebietet das Betriebsstättendiskriminierungsverbot des Art 25 Abs 3 DBA Niederlande die Berücksichtigung des Verlustvortrages unabhängig von der in § 102 Abs 2 Z 2 EStG enthaltenen Voraussetzung des Übersteigens der nicht der beschränkten Steuerpflicht unterliegenden Einkünfte."* This is the general approach taken in Austrian case law: if there is no possibility that the losses are used twice (whatever the reason, for instance if the taxpayer's State of residence does not allow foreign losses to be deducted), then the carry-over should be granted to the non-resident's PE; see G. KOFLER, "Der Verlustvortrag für beschränkt Steuerpflichtige nach § 102 Abs. 2 Z 2 EstG", *SWI* 2009, 480-483. The same approach is taken in several opinions issued by the Austrian

Put briefly, the Court decides that the PE should be entitled to the loss carry-forward in Austria in 2000 on the condition that the taking into account of the loss in 1999 in the Netherlands has been neutralised there by a proportionate reduction of the credit for 2000.

The Court came to the same conclusion in a similar case of 28 November 2007. A company established in Switzerland had a PE in Austria. From 1994 to 1998, the taxpayer suffered losses in Austria. In 1999, it made a profit in Austria. The taxpayer requested the Austrian tax authorities to carry over the losses of the previous years. Because the taxpayer had deducted the losses of the Austrian PE in Switzerland, the tax authorities dismissed the taxpayer's request. However, Swiss tax law provided that such foreign losses were subsequently recovered if the foreign PE made profits during the following seven years[477].

Once again, the Court decided in favour of the taxpayer and held that the PE non-discrimination clause required Austria to apply the loss carry-over if no double loss deduction was possible[478].

In both cases, the Court thus takes account of the head office's tax position when determining whether the PE is entitled to the benefit in Austria. Unfortunately, because the decision is very concise, it is unclear whether the Court takes the head office's tax position into account in the comparability-test or in another step of its analysis.

If the Court indeed took the head office's tax position into account in its comparability-test, then its position is difficult to reconcile with the approach taken in the judgments that were discussed earlier (e.g. Bundesfinanzhof 22 April 1998). In those judgments, there was a tendency to consider the PE in isolation, without interference from the head office's tax position. Here, however, the Court takes the tax position of the head office into account in order to determine whether double loss deduction is possible (which would preclude the application of the loss carry-over in Austria). In other words, the Court seems to verify whether the situations are rendered incomparable because, in the case of the subject of comparison, there is a risk that the losses will be used twice. Arguably, this different approach can be explained by the influence of the ECJ's case law on the interpretation given by the tax authorities and courts in Austria to Art. 24 OECD MC[479]. For instance, it has been suggested

---

Bundesministerium für Finanzen; see e.g. EAS 1528 and 2345, on the treaty with France: as the Austrian PE losses cannot be taken into account in France, given France's adherence to the territoriality principle, there is no possibility that the losses would be used twice (*"wenn kein Risiko einer Verlustdoppelverwertung besteht, [dann kann] die inländische Betriebstätte unter gleichen Bedingungen wie ein unbeschränkt steuerpflichtiges Unternehmen das Recht des Verlustvortrages in Anspruch nehmen. Der Umstand, dass nach französischem Recht bei der Besteuerung der Kapitalgesellschaften das Territorialitätsprinzip angewendet wird, und dass daher - auch bei ausreichend hohem Einkommen der französischen Kapitalgesellschaft - Gewinne und Verluste ausländischer Betriebstätten bei der Besteuerung in Frankreich unberücksichtigt bleiben, gewährleistet nach dem gegenwärtigen Wissensstand des BM für Finanzen, dass keine schädliche Verlustdoppelverwertung zu erwarten ist"*). See also e.g. EAS 1874 and 1894, on the treaty with Germany, and EAS 2034, on the treaty with Switzerland.

477 In the ECJ case C-157/07, *Krankenheim*, 23 October 2008, the European Court of Justice decided on the compatibility with EU law of a German loss recapture system which was very similar to the system applied by Switzerland in the present case. *Krankenheim* will be discussed in Part III, 2.E.I.A.b.3.d.

478 *"In Fällen, in denen DBA […] die Befreiungsmethode anwenden und DBA-Partnerstaaten in ihrem innerstaatlichen Recht eine ausdrückliche Verlustausgleichsmöglichkeit mit den österreichischen Betriebsstättenverlusten zulassen […] wird das Betriebsstättendiskriminierungsverbot somit nur dann zum Verlustvortrag berechtigen, wenn keine doppelte Verlustverwertung eintritt."*

479 See also Part IV, 2.B.

that a number of unresolved issues under Art. 24(3) have been decided in Austria by drawing inspiration from the case law of the ECJ, e.g. the loss carry-over system discussed here, or the affiliation privilege[480].

The approach taken by the tax authorities and courts in Austria has been criticized in literature, on the basis that the tax treatment of the PE-profits or -losses at the head office level should not affect the analysis under Art. 24(3). Rather, preventing that losses may be deducted twice is the responsibility of the taxpayer's State of residence[481]. To some extent, I agree with this criticism. As mentioned earlier, the basic position should be that the tax position of the PE is considered in isolation, without taking account of what happens at the level of the head office. The head office's tax position should only be taken into consideration if it is relevant for the tax position of the PE. With regard to the possibility to carry over losses, the tax position of the PE is generally not affected by the possibility that the head office has already deducted those losses. Consequently, that possibility should not be taken into account in constructing the subject and object of comparison. Instead, the Court should have considered the PE's tax position in isolation.

This conclusion obviously affects the disadvantage-test: as the subject of comparison in the present case should be limited to the PE in isolation, the PE is being treated less favourably than a resident enterprise regardless of the situation at the level of the head office. In particular, if the subject of comparison consists of the PE considered in isolation, it is clear that there is a disadvantage: unlike a resident, the PE is unable to carry over the losses and deduct them in a subsequent year when a profit is made. However, if the subject of comparison is constructed by considering the overall tax position of the taxpayer (i.e. by taking account of the tax position of both the PE and the head office) the disadvantage disappears. As the losses in question have already been taken into account at the level of the head office, the non-resident taxpayer is not treated less favourably than a resident taxpayer if the PE State denies the loss carry-over. Conversely, where the taxpayer's State of residence subsequently recaptures the losses, the PE State can no longer deny the carry-over, given the disadvantage incurred by the non-resident taxpayer (considered on an overall basis) in that case. This issue will be further explored in the discussion of the disadvantage-test under Art. 24(3) (see 2.D.III).

On the other hand, it is also possible that the Court did not take account of the head office's tax position as an aspect of its comparability-test, but instead considered that preventing the double use of losses constitutes a valid justification for the discrimination. This possibility will be addressed in Part IV, 2.B.I.A.d.

---

480 See G. TOIFL, "Austria", in *Cahiers de droit fiscal international. Non-discrimination at the crossroads of international taxation*, Vol. 93a, Amersfoort, Sdu Fiscale & Financiële Uitgevers, 2008, 125. See also the opinion issued by the Austrian Bundesministerium für Finanzen concerning the treaty with France, referred to above (EAS 2345), where it is expressly held that Art. 24(3) has to be interpreted in accordance with the prohibition of discrimination as it results from the fundamental freedoms: *"Das Diskriminierungsverbot des DBA-Frankreich,* ***das im Rahmen seines Anwendungsbereiches im Gleichklang mit den aus den Grundfreiheiten des EG-Vertrages resultierenden Diskriminierungsverboten ausgelegt wird****, nötigt dazu, die inländischen Betriebstätten ausländischer Unternehmen nicht schlechter zu behandeln als vergleichbare inländische Unternehmen"* (emphasis added).

481 E.g. K. VOGEL and M. LEHNER, *Doppelbesteuerungsabkommen*, Verlag C.H. Beck, München, 2008, 5 Auflage, 1718; H. ZOCHLING, "Austria", in IFA, *Non-discrimination rules in international taxation. Cahiers de droit fiscal international*, Vol. LXXVIIIb, Amersfoort, Sdu Fiscale & Financiële Uitgevers, 1993, 309-310.

b. Case law on the object of comparison

Case law on the construction of the object of comparison is surprisingly scarce, particularly taking into account the vagueness of the phrase 'carrying on the same activities'. The *Reuters* case, discussed above, is an example of a case where the meaning this phrase was expressly addressed. However, the outcome of that case was greatly affected by the particularities of the New York tax system at issue.

1. Swiss Bundesgericht 28 November 2005[482]

The taxpayer was a French bank with a PE in Switserland, in the canton of Zürich[483]. In the tax year at issue, the taxpayer realized profits in the Swiss PE but incurred losses abroad. The tax authorities assessed the taxpayer to Swiss tax in respect of the PE's profits, without taking account of the taxpayer's overall losses. Article 7(2) of the treaty (which is identical to Art. 7(2) OECD MC) provided that a direct method should be followed in respect of the allocation of profits between the head office and the PE (i.e. separate entity approach). Under Art. 7(4) of the treaty (which is identical to Art. 7(4) OECD MC), the parties were allowed to apply an indirect method (apportionment of the total profits) insofar as it has been customary in that State. However, according to Swiss domestic law at the material time, in the case of foreign losses of the non-resident head office, the Swiss PE was taxed as a separate enterprise. Consequently, the separate entity approach had to be applied.

The taxpayer objected against this assessment, on the basis that it was contrary to the PE non-discrimination clause of the French/Swiss treaty[484]. According to the taxpayer, the comparison had to be made with an enterprise established in Switzerland that had a PE in Zürich, but the head office of which was situated in another canton. In such a case, the overall result of the entity would be taken into account[485]. As a result, if the taxpayer's place of residence had been in Switzerland instead of in France, no Swiss tax would be due on the PE's profits, as these profits would be set off against the overall loss. In contrast, where the head office was situated outside Switzerland, the PE was deemed to be a separate entity for tax purposes in Switzerland.

The first instance court dismissed the taxpayer's claim and held that the appropriate object of comparison was not a Swiss resident that did business in another canton through a PE, but a taxpayer that was subject to unlimited taxation in Zürich, i.e. an enterprise established there[486]. On appeal, the Bundesgericht confirmed this interpretation. The Court first noted that the non-resident taxpayer's PE had to be compared with a resident enterprise, which constitutes a self-contained entity (*"ein inländisches Unternehmen, das eine in sich*

[482] *Steuerrevue / Revue Fiscale* 2006, 433.
[483] The 26 cantons of Switserland are the member states of the federal State of Switzerland. Each canton has its own constitution and has fiscal sovereignty (with the exception of certain matters that have been transferred to the federal government).
[484] Art. 26(3) of the 1966 treaty, which is identical to Art. 24(4) of the 1963 OECD Draft Convention.
[485] Under Swiss domestic law, the intercantonal rules for the allocation of business profits between a head office and its PE function on the basis of the indirect method of allocation, i.e. by apportioning the total profits of the enterprise to the PE on the basis of a proportionality factor; see X. OBERSON and H. HULL, *Switzerland in international tax law*, Amsterdam, IBFD, 2006, 106-107.
[486] *"als Vergleichsmassstab sei nicht ein interkantonales Unternehmen heranzuziehen, sondern ein im Kanton Zürich unbeschränkt steuerpflichtiges, d.h. dort ansässiges Unternehmen."*

geschlossene Einheit darstellt")[487]. In respect of the possibility for the PE of a non-resident to carry forward losses, the Court stresses that this possibility concerns the loss on its own business activity, as shown in the PE's separate accounts for these activities[488]. Finally, the Court notes that, with regard to the applicable tax rate, the PE-State is entitled to apply the progessive scales that apply to resident companies to the profits of the PE, thereby disregarding the profits of the company as a whole, even where the latter profits are lower than those of the PE[489].

From the perspective of these observations in the OECD Commentary, the Court concludes that the PE should not be compared to a Swiss resident that did business in another canton through a PE, but a taxpayer established and subject to unlimited taxation in Zürich[490]. The Court therefore decided that the taxation of the PE in Switzerland did not constitute discrimination under the tax treaty, as the PE was not treated less favourably than a resident taxpayer established in Zürich and carrying on the same activities.

2. Finanzgericht Köln 20 September 1995[491]

The taxpayer, a company resident in the U.K., leased a hotel in Germany in order to operate it for profit. Before the lease contract took effect, the taxpayer incurred costs in respect of legal advice relating to the transaction. The taxpayer deducted these costs in his tax return for purposes of the German trade tax (a German tax on business profits), but the German tax authorities disallowed the deduction because the consulting fees had been incurred before the start of the business activities. The taxpayer argued that this constituted discrimination of its PE under the German/U.K. tax treaty[492], because a resident company would have been able to deduct such costs.

The Court dismissed the taxpayer's claim. The Court noted that the consulting fees were preparatory expenses that were not deductible for purposes of the German trade tax. The German trade tax applied to all business operating in Germany, including PEs of non-resident taxpayers. However, at the time when the consulting fees arose, the taxpayer did not conduct any business in Germany. The taxpayer could only be said to conduct business in Germany **after** the hotel had opened for business[493].

---

[487] The expression *"ein inländisches Unternehmen, das eine in sich geschlossene Einheit darstellt"* is the German translation of Comm. OECD on Art. 24, para. 39, the third sentence of which reads as follows: *"The situation of the permanent establishment is different from that of* ***a domestic enterprise, which constitutes a single entity*** *all of whose activities, with their fiscal implications, can be fully brought within the purview of the State where it has its head office"* (see K. LOCHER (ed.), *Doppelbesteuerungsabkommen Schweiz – Deutschland 1971 und 1978. Teil B: Praxis DBAD 71*, VRG Verlag, Therwil, loose-leaf, B 25.2, No. 1-11, para. 23). Admittedly, the German 'eine in sich geschlossene Einheit' is slightly more imaginative than the English 'a single entity' for the purpose of constructing an object of comparison.
[488] See Comm. OECD on Art. 24, para. 40(c).
[489] See Comm. OECD on Art. 24, para. 56.
[490] As will be pointed out below, the question regarding the compatibility of the U.S. branch tax on excess interest with Art. 24(3) depends on whether the comparison is made with a resident taxpayer paying interest to another resident, or with a resident taxpayer paying interest to a non-resident. If the former comparison is the appropriate one, there is discrimination contrary to Art. 24(3). The construction of the object of comparison as a 'self-contained entity' by the Swiss Bundesgericht might indicate that the appropriate comparison is indeed with an interest payment made to another resident. This issue will be addressed 2.D.III.B.b.3.
[491] *Entscheidungen der Finanzgerichte (EFG)* 1995, 1110.
[492] Article XX(3) of the 1964 treaty, identical to Art. 24(4) of the 1963 OECD Draft Model Convention. The taxpayer also relied on the freedom of establishment. The Court applied the same reasoning to both arguments.
[493] *"Zum Zeitpunkt der wirtschaftlichen Entstehung der Rechts- und Beratungskosten war die inländische Betriebstätte jedoch der Klägerin noch nicht zuzurechnen; sie sollte vielmehr erst erworben werden. Die*

The German trade tax applied to the operating of a business in Germany. For residents and non-residents alike, the tax was levied on the carrying on of a business in Germany. It was not the valid incorporation of the company that gave rise to tax liability, but the carrying on of a business by that company. For the taxpayer at issue, this was only the case after the hotel had opened for business. In this respect, the taxpayer was comparable to a German resident company during its incorporation[494]. Under German domestic law, a resident company during the course of its incorporation (a 'Vorgesellschaft') could be liable to trade tax, but only insofar as it carried on a business in Germany. For that reason, it was irrelevant that the taxpayer already carried out a business activity abroad.

Consequently, the Court held that there was no discrimination. The taxpayer's PE was treated identically to a German resident company during the course of its incorporation: both were only subject to the trade tax from the moment they carried on a business activity in Germany[495].

Put briefly, for purposes of a German trade tax that was levied on business activities carried on in Germany, a non-resident taxpayer who incurred costs relating to his German PE before that PE began its operations had to be compared to a resident company carrying on the same activities, during the course of its incorporation. As both subject and object of comparison were only liable to the trade tax (and, therefore, entitled to deduct costs) from the moment they started their business activities, there was no discrimination.

The Court also makes an interesting observation as regards the subject of comparison: as the trade tax was levied on business activities carried on in Germany, it was irrelevant for the comparison that the taxpayer already carried on business activities in his home State[496]. This is in line with the remarks made earlier, that the PE has to be considered in isolation (i.e. without taking account of the tax position of the head office), unless the tax position of the head office is relevant for the purpose of the tax measure at issue. In the present case, the measure at issue was only concerned with activities carried out in Germany. Accordingly, it was irrelevant that the head office of the taxpayer already carried out activities elsewhere.

3. UBS AG

The taxpayer in this case was a Swiss bank with a PE in the U.K. In the years at issue, the PE had accumulated substantial trading losses from the conduct of its banking business in the U.K. The PE acted as a market maker, i.e. it quoted both a buy and a sell price in securities,

---

Klägerin konnte mangels inländischer Betriebsstätte noch nicht am Marktgeschehen teilhaben. Dies war erst mit der definitiven Übernahme des Hotels am 29.11.1984 der Fall. Erst ab diesem Zeitpunkt ist die Klägerin […] in die inländische Gewerbebesteuerung 'hineingewachsen'."

494 *"Die Klägerin ist nach Ansicht des Senats bezüglich des Hineinwachsens in die inländische Besteuerung* ***einer inländischen Kapitalgesellschaft während ihrer Gründungsphase*** *vergleichbar"* (emphasis added).

495 *"Die Klägerin wird insoweit nicht anders behandelt als inländische Unternehmen, die sich in der Gründungsphase befinden und erst mit der eigentlichen Aufnahme der gewerblichen Betätigung der Gewerbebesteuerung unterliegen. Dies gilt auch für inländische Kapitalgesellschaften, für die […] der BFH […] ausgeführt hat, daß nicht schon die Gründung, sondern die Tätigkeit einer Kapitalgesellschaft als Gewerbebetrieb anzusehen ist."*

496 *"Insoweit kann sich die Klägerin auch nicht auf ihre unstreitige ausländische Marktteilhabe berufen, weil § 2 Abs. 1 Satz 3 GewStG ausdrücklich auf das Inland abstellt."*

hoping to make a profit on the spread[497]. In the course of its activities, the PE received dividends from U.K. resident companies and it received and paid 'manufactured dividends'[498]. The manufactured dividends **received** arose primarily in consequence of stock lending transactions engaged in by the PE, as a result of which the PE did not receive the dividends to which it would otherwise have been entitled. To compensate for the loss of the dividend, the borrower paid a manufactured dividend to the PE. The manufactured dividends **paid** arose primarily in the same circumstances, but with the PE as the borrower rather than the lender. For purposes of the present issue, manufactured dividends were treated in exactly the same way as real dividends received or paid.

During the years at issue, the surplus of U.K. dividends and manufactured dividends received by the PE over manufactured dividends paid amounted in value to approximately £ 230 million. Had the PE been a U.K. resident taxpayer, the surplus would have carried with it tax credits of approximately £ 58 million. The taxpayer argued on the basis of the PE non-discrimination provision of the applicable tax treaty[499] that this credit should also be granted to the PE.

The disadvantage at issue (which will be discussed in detail in 2.D.III.C.c.1) was that the PE, unlike a U.K. resident company, was not entitled to relief for either dividends received or manufactured dividends received. Neither was the PE entitled to relief for manufactured dividends paid, but that was exactly the same for a U.K. resident company. As there was no difference in tax treatment between dividends and manufactured dividends, I will not make any further reference to manufactured dividends.

The Special Commissioners[500] first refer to a number of passages in the Commentary, which *"recognise the problems of equating a permanent establishment with a company"*[501]. The Special Commissioners then note that the PE non-discrimination provision requires a comparison between the taxation on the PE and the taxation on a U.K. resident company carrying on the same activities to determine whether the taxation is less favourably levied on

---

497 Market makers guarantee the liquidity of the listed shares by ensuring that investors are able to trade in them at all times. By being registered as a market maker in a particular stock, the dealer is obliged to quote two-way prices in that stock ('bid/offer' prices, reflecting the prices at which it is willing to buy and sell shares respectively). Market makers generate profits in a variety of ways, for instance by offering to buy shares at a lower price than that at which they offer to sell them, or by holding a long (or short) position in a share if they think the price of that share is likely to rise (or fall). Given the large size of market makers' shareholdings and the type of transactions in which they are involved, market makers obviously receive a substantial amount of dividends and receive and pay a substantial amount of manufactured dividends (see hereafter).

498 A manufactured payment is a payment that is representative of dividends or interest payable on securities, arising as a result of transactions in these securities (especially sale and repurchase or stocklending transactions). More specifically, when lending shares (or other securities), the lender generally maintains the right to ownership of the dividend payments (or other disbursements). Consequently, the borrower is responsible for payment of (an amount equal to) such distributions when they occur. As this payment does not come from the company whose shares are concerned, it is technically not a dividend. This is a 'manufactured dividend'. The same occurs when a trader short-sells shares: the trader borrows the shares and sells them to a buyer. When a dividend is distributed, it is paid to the new buyer. However, the lender of the shares (who is not necessarily aware that the shares are being lent out for shorting) also expects to receive a dividend. Therefore, the short seller will have to pay the lender an amount equal to the dividend in order to compensate, i.e. the 'manufacted dividend'.

499 Art. 23(2) of the 1977 treaty between the U.K. and Switzerland, identical to Art. 24(4) of the 1963 OECD Draft Convention.

500 Special Commissioners 7 June 2005, *UBS AG v Revenue and Customs Commissioners*, 7 *ITLR* 893, 908.

501 Particularly Comm. OECD on Art. 24, paras. 34, 35 and 39 (which, at the time, were numbered 22, 23 and 25).

the PE. Consequently, the core issue is identifying the appropriate object of comparison[502]. According to the Special Commissioners, the same activities requirement means, first of all, that the hypothetical U.K. resident company is a market maker. Secondly, the parties agreed that the object of comparison should have exactly the same tax losses and receive the same dividends and manufactured dividends as the PE and should pay the same manufactured dividends. Beyond that, however, there was disagreement between the parties.

The tax authorities argued that the profit distribution between PE and head office should also be taken into account. The PE distributed all its profits to its head office. Therefore, since the issue concerned tax credits which were part of the imputation system of dividends, the tax authorities contended that the object of comparison should also have distributed its profit to its parent. In that case, the object of comparison would not have been able to invoke s 243 ICTA 1988 because, on the facts, its franked payments in the years at issue would have exceeded its franked investment income[503]. The taxpayer disagreed, arguing that profit distribution was irrelevant.

The Special Commissioners agreed with the taxpayer: *"We do not consider that profit distributions should be included in the comparison. It is the nature of a permanent establishment that it cannot pay dividends and so that is outside the comparison; indeed if it were, under a classical corporation tax system on which the Model is based, such a comparison would imply that a State could impose a branch profits tax as equivalent to the withholding tax on dividends without breaching the non-discrimination article, which cannot be right. [The tax authorities] did not go this far but [they] included the payment of dividends in the comparison in this case because the imputation system and tax credits were bound up with the payment of dividends. We consider that it is inherent in any comparison between a permanent establishment and a resident company that one must ignore the distribution of profits. The two entities are different in this respect and no meaningful comparison can be made"*[504].

As the PE was treated less favourably than the object of comparison, the Special Commissioners ultimately decided that there was discrimination[505].

The High Court agreed with the Special Commissioners on this point[506]. The Court notes that any profits generated by the activities of a PE as defined in Art. 5 OECD MC *"necessarily belong to the enterprise of which it forms part. There is no question of any payment of dividends by the permanent establishment. It cannot sensibly have been the intention of the parties to the treaty to make the Art. [24(3)] comparison on the hypothesis that the permanent establishment was making payment of share dividends to a parent company equal to all its distributable profits."* On appeal, the tax authorities also referred to Art. 7(2) OECD MC in order to support their argument[507], but the High Court dismissed this line of reasoning. The Court holds that Art. 7 deals with an entirely different issue, namely what part of the profits

---

[502] In the judgment, the object of comparison is referred to as the 'comparator'.
[503] For the relevance of the relationship between franked payments and franked investment income, see 2.D.III.C.c.1.
[504] Special Commissioners 7 June 2005, *UBS AG v Revenue and Customs Commissioners*, 7 *ITLR* 893, 908-909.
[505] The determination of whether there was less favourable treatment will be discussed in 2.D.III.C.c.1.
[506] High Court (Chancery Division) 7 February 2006, *UBS AG v Revenue and Customs Commissioners*, 8 *ITLR* 595, 611-612.
[507] Presumably because Art. 7(2) refers the profits which the PE might be expected to make *"if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a [PE]."*

generated by the enterprise can fairly be attributed to the activities of the PE. Moreover, on the facts of the case, if the PE had been a separate company, it could not have declared dividends in view of the losses that had been incurred.

Finally, the Court of Appeal also reached a similar conclusion[508]: *"I consider that the comparison which must be made in this context is with the specific activity which the permanent establishment is carrying on and on which it is being taxed, and no other. Accordingly, no relevant comparison falls to be made with a U.K. enterprise which itself makes distributions. Put another way, it cannot be said that the system of taxation on permanent establishments was less favourable simply because they could not utilise the tax credit in operations (here, the making of distributions) which they could not carry out"*[509].

In other words, it is inherent in the concept of a PE that it cannot distribute dividends. Therefore, this characteristic should be left out of the analysis when constructing the object of comparison. Otherwise, no meaningful comparison could be made[510].

III. The disadvantage test: 'taxation … less favourably levied'

III.A. 'Taxation'

Article 24(3) states that 'the taxation on a PE' which an enterprise of a Contracting State has in the other Contracting State must not be less favourably levied than the taxation levied on enterprises of that other State carrying on the same activities. The interpretation of the term 'taxation on a PE' in Art. 24(3) may seem very obvious at first sight, but it has nevertheless given rise to some difficulty in practice. That is to say, it may be difficult in practice to determine whether the alleged discrimination concerns 'taxation', and, if so, whether it concerns taxation 'on a PE'. For an example of the former question, see the *UBS*-case (which will be discussed in 2.D.III.C.c.1) where the question arose whether the payment of a tax credit formed part of 'the taxation'.

An example of the latter issue (taxation 'on a PE') is the treatment of a non-resident who disposes of his PE: does the tax treatment in the PE State of this reorganization form part of

[508] That is to say, Arden LJ reached a similar conclusion. The two other judges of the Court of Appeal did not address this issue; see 2.D.III.C.c.1.

[509] Court of Appeal (Civil Division) 21 February 2007, *UBS AG v Revenue and Customs Commissioners*, 9 *ITLR* 767, 794-795.

[510] See also 2.D.III.B.b.3, on branch profits taxes: the Commentary observes that, even though a branch tax expressed as an additional tax payable on the profits of the PE may be equivalent to the withholding tax levied on distributions made by a subsidiary of a non-resident, it nevertheless constitutes discrimination contrary to Art. 24(3). Accordingly, the PE State is not allowed to levy a tax on the PE to compensate for the absence of a taxable dividend distribution. The Commentary discusses this as an aspect of the disadvantage-test, but it might be more rational to see it as an element of comparability: as it is inherent in the PE's nature that it cannot distribute profits, this characteristic should be left out of the analysis when constructing the comparison. Once again, this demonstrates the close connection between comparability and disadvantage: if a certain characteristic is taken into consideration in constructing the object of comparison, it determines the treatment to which the treatment of the PE (i.e. the subject of comparison) is compared. In the present case, if tax consequences of dividend distributions are left out of the analysis when constructing the object of comparison, they do not affect the disadvantage-test. That is to say, if the taxation of a resident company upon the distribution of profits is left out of the analysis when constructing the object of comparison, the PE State can no longer refer to the compensating nature of the branch profits tax in order to argue that the PE is not treated less favourably than a resident company.

‘the taxation on the PE’? In particular, the question arises whether the PE State violates Art. 24(3) by applying a beneficial regime (e.g. tax deferral) to reorganizations carried out by resident enterprises, while refusing this regime to non-residents who dispose of their PE. After the reorganization, the PE no longer exists, so the PE State could argue that there is no discrimination (since there is no PE).

The starting point here should be that Art. 24(3) offers non-residents protection from discrimination as soon as their presence in the other Contracting State reaches a certain threshold: the non-resident is only entitled to protection under Art. 24(3) if his presence in the other Contracting State is sufficient to constitute a PE. As soon as this threshold is reached, the non-resident is offered protection from discrimination as regards his PE, i.e. his tax position as regards the PE should not be less favourable than the tax position of a resident taxpayer carrying on the same activities. This is a first indication that the prohibition of discrimination extends to the tax treatment upon the discontinuation of the PE: the tax treatment of the disposal of the PE certainly forms part of the non-resident’s tax position as regards the PE.

Secondly, Art. 13(2) OECD MC provides: *“gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State”*. The Commentary clarifies this as follows: *“[Art. 13(2)] makes clear that its rules apply when movable property of a permanent establishment is alienated as well as when the permanent establishment as such (alone or with the whole enterprise) is alienated. If the whole enterprise is alienated, then the rule applies to such gains which are deemed to result from the alienation of movable property forming part of the business property of the permanent establishment. The rules of Article 7 should then apply mutatis mutandis without express reference thereto”*[511].

> See also Comm. OECD on Art. 24, para. 40: *“permanent establishments should further have the same rules applied to resident enterprises with regard to the taxation of capital gains realised on the alienation of assets, whether during or on the cessation of business.”* This paragraph confirms that the alienation of individual assets, attributable to the PE, is governed by the non-discrimination provision, even if that alienation takes place on the cessation of the PE’s business. Even though this paragraph does not mention the alienation of the PE as a whole, it seems to be a confirmation of the rule laid down in Art. 13(2), that gains from the alienation of the PE’s movable property are taxed under Art. 7, and, therefore, governed by Art. 24(3). The opposite approach – i.e. that Comm. OECD on Art. 24, para. 40 implies that gains realised on movable property when the PE as a whole is alienated do not fall under Art. 24(3) – is not very convincing. The main argument against Art. 24(3) applying to gains realised when the PE as a whole is alienated is that the PE no longer exists after the alienation. However, the same problem arises with regard to the alienation of individual assets when the PE’s business is discontinued: given that the Commentary confirms that Art. 24(3) applies to gains on individual assets when the PE is terminated, it makes no sense to deny application of Art. 24(3) to gains on such assets when the PE as a whole is alienated[512].

[511] Comm. OECD on Art. 13, para. 25.
[512] See also N. SACCARDO, “Art. 24(3) of the OECD Model Convention: the significance of the expression ‘taxation on a permanent establishment’ in cross-border reorganizations”, *Intertax* 2003, 278.

When a capital gain is realised on the PE's movable property, the rules of Article 7 apply, irrespective of whether the assets are disposed of individually or whether the PE as a whole is alienated. The rules of Art. 7 thus apply to the gains realised when the non-resident disposes of his PE. As pointed out in 2.D, Article 24(3) ensures non-discriminatory treatment of the PE when business profits are attributed to the PE under Art. 7. This also includes the treatment of the gains realised upon the discontinuation of the PE, which fall under Art. 7 by virtue of Art. 13(2). Conversely, income from immovable property of the PE does not fall under the business profits-rule of Art. 7. Instead, Art. 6 and Art. 13(1) apply (the latter provision governing the gains from the alienation of the property). As a result, the taxation of this income does not seem to fall under the non-discrimination rule of Art. 24(3), since this is not 'taxation on a PE' within the meaning of Art. 24(3).

This has the counterintuitive result that Art. 24(3) precludes the PE State from discriminating the non-resident as regards gains on movable property realized when the PE is disposed of, but nothing in that provision precludes the PE State from discriminating the non-resident as regards gains on immovable property. A textual reading of the treaty would therefore allow the PE State to restrict a beneficial tax regime (e.g. tax deferral) in respect of gains on immovable property to residents, excluding gains realised upon the disposal of a non-resident's PE. Since income from immovable property is excluded from the scope of application of Art. 7, this differential treatment goes beyond the scope of Art. 24(3). On the other hand, such a beneficial tax regime should be extended to the non-resident's PE in respect of gains from the alienation of movable property. This result may seem strange, but it results from the fact that the scope of Art. 24(3) is restricted to business profits attributable to the PE under Art. 7[513].

> An interesting example of this approach can be found in a judgment of the Austrian Constitutional Court of 15 March 1990[514]. The taxpayer was a Portuguese resident who derived income from agriculture and forestry in Austria. Under Art. 6 of the treaty, the income was taxable in Austria. Austrian domestic law provided for a possibility to carry forward losses from agriculture and forestry, but this possibility was restricted to residents. The taxpayer invoked Art. 24(3) of the treaty, arguing that he should be able to carry over his losses in Austria. The Court dismissed that argument, pointing out that the scope of application of Art. 24(3) was limited to business profits covered by Art. 7. Consequently, it could not be relied on in respect of discriminatory treatment of other income[515].
>
> The taxpayer then argued that the limitation of Art. 24(3) to business income was contrary to the (Austrian) Constitutional principle of equality, because it meant that a distinction was made between business profits and income from agriculture and forestry. The Constitutional Court dismissed this argument as well. The Court first pointed out that the terminology of Art. 24(3) ('permanent establishment', 'an enterprise of a Contracting State') was only used in the treaty in the context of business profits (Art. 7). The structure and system of the treaty implied that other items of income, e.g. income covered by Art. 6 or Art. 14, were not

[513] One might be tempted to consider in this context that the term 'permanent establishment' has a different meaning in Art. 24(3) as compared to the rest of the OECD MC, on the basis of which it could be argued that the scope of Art. 24(3) is broader than that of Art. 7. However, that position is not very convincing since Art. 5 OECD MC defines the term 'permanent establishment' *"for the purposes of this Convention"*, without making an exception for Art. 24(3). See also M. LANG, "The concept of permanent establishment and its interpretation", *Rivista di Diritto Tributario Internazionale* 2002, No. 1/2002, 19.
[514] Verfassungsgerichtshof 15 March 1990, B758/88, B759/88, IBFD Tax Treaty Case Law Database.
[515] *"Der Begriff der Betriebstätte habe aber nur für die Besteuerung von Unternehmensgewinnen im Sinne des Art7 Bedeutung. Das Verbot der Diskriminierung von Betriebstätten sei daher auf Verluste aus Land- und Forstwirtschaft beschränkt Steuerpflichtiger nicht anwendbar."*

covered by this provision. The same approach, i.e. that Art. 24(3) only applied to income from business activities, is also taken by the Commentary (see Comm. OECD on Art. 24, para. 35) and in legal writing[516]. As the limitation of the PE non-discrimination provision to business income was in accordance with international practice, it was a legitimate exercise of the legislator's political discretion to follow the international standard in this context. As a result, this limitation was not contrary to the Constitutional principle of equality[517].

III.B. 'Less Favourably levied'

Unlike Arts. 24(1), (2) and (5) – which prohibit 'other or more burdensome' taxation – Art. 24(3) only prohibits taxation that is 'less favourable'[518]. The reason for this distinction is that PEs are, by definition, different from resident enterprises, as a PE is not a separate legal entity but only a part of an enterprise with its head office in another State. This explains why the Comm. OECD provides that it is not discriminatory to tax non-residents **differently** from residents, for practical reasons, as long as this does not result in **more burdensome** taxation for the former than for the latter[519]. Accordingly, it is permitted to adapt the mode of taxation

---

[516] *"Die Vorschrift verwendet eine Terminologie ('Betriebstätte', 'Unternehmen eines Vertragstaates'), die im Abkommen nur im Zusammenhang mit der Besteuerung von Unternehmensgewinnen (Art. 7) verwendet wird. Aus der Systematik des Abkommens ergibt sich, daß es sich hiebei um Einkünfte handelt, die keine Einkünfte aus land- und forstwirtschaftlicher Tätigkeit oder aus freiberuflicher Tätigkeit sind: Einkünfte aus Land- und Forstwirtschaft sind in Art. 6, Einkünfte aus freien Berufen in Art. 14 geregelt. Dementsprechend geht auch der Kommentar der OECD zum Musterabkommen davon aus, daß Art. 24 Z4 sich lediglich auf gewerbliche Unternehmen bzw. Betriebstätten gewerblicher Unternehmen beziehe […]. Diese Auffassung findet sich auch übereinstimmend in der einschlägigen Kommentarliteratur."*

[517] *"Wenn sich der Gesetzgeber entschließt, im Zuge des Abschlusses von Doppelbesteuerungsabkommen diese Ungleichbehandlung in bestimmten Bereichen einzuschränken, so liegt es in seinem rechtspolitischen Ermessen, die Gleichbehandlung nur in Fällen zu gewähren, für die sich ein internationaler Standard herausgebildet hat, sodaß sie von besonderer Bedeutung erscheinen und sich in bilateralen Verhandlungen auch durchsetzen lassen. Die internationale Vertragspraxis auf dem Gebiet der Doppelbesteuerungsabkommen hat nun aber eine Gleichbehandlung im Bereich der einzelnen Einkunftsarten bisher nur auf dem Gebiet der gewerblichen Betriebsstättengewinne für erforderlich gehalten […]."*

[518] Working Party no. 4 of the OEEC Fiscal Committee also proposed to use the expression 'less favourable' (see 1.C). The Swiss delegation suggested to use 'other, higher or more burdensome', which, at the time, was the expression used in the proposed nationality non-discrimination clause. The Working Party dismissed that proposal, pointing out that "a more restricted provision" would be preferable because the wider draft proposed by the Swiss delegation would have "greater repercussions" on the Member countries' national legislation than the nationality non-discrimination rule (see FC/WP4(57) 2, 6-7.).

[519] See, for instance, High Court, Chancery Division, 17 April 1984, *Sun Life Assurance Co of Canada v Pearson* [1984] S.T.C. 461. The taxpayer in that case was a Canadian insurer with a PE in the U.K. Under U.K. tax law at the time, the taxable profit of a non-resident insurer with a U.K. branch was deemed to be a proportion of the company's income from the investments of its life assurance fund worldwide. The taxpayer argued that this fell foul of the PE non-discrimination provision of the Canadian/U.K. treaty. The Court dismissed this claim, holding that *"it is not permissible to rely on [Art. 24(3)] solely on the ground that the provision […] results in a higher tax burden in a given year than the burden which would have fallen on the branch if it had been an enterprise resident in the United Kingdom. Moreover, […] Art. 7(6) specifically provides: 'For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.' The consistent application of the same principle will almost inevitably produce results which will differ from year to year to a greater or lesser extent from those that would have been produced from the taxation of the company as a separate enterprise resident in the United Kingdom and which may in some years be more and in other years less favourable."* The Court had earlier decided that the apportionment method under U.K. tax law was consistent with Art. 7 of the treaty, because it was preserved by Art. 7(4). Consequently, the issue here is that discriminatory treatment resulting from domestic law is expressly confirmed in the tax treaty of which Art. 24(3) is invoked. As discussed in 2.B.VI.D.b and 2.D.III.C.e, Art. 24 should be set aside when it was the intention of the Contracting States to confirm a discriminatory domestic regime in the tax treaty. Here, it is clear that the Contracting States intended to deviate from the PE non-discrimination principle in allowing the application of an

to the particular circumstances in which the taxation is levied (and, particularly, taking into account the fact that the PE is not a separate legal entity), as long as the resulting taxation is not less favourable[520] [521].

Furthermore, Art. 24(3) only refers to the 'taxation', while Arts. 24(1), (2) and (5) refer to 'taxation and connected requirements'. This distinction is also explained by the fundamental difference between PEs and resident taxpayers: for practical purposes, it may be necessary to treat PEs differently as regards requirements connected with the taxation from resident taxpayers[522].

It is not entirely clear whether 'less favourable taxation' in Art. 24(3) means the same as 'more burdensome taxation' in Art. 24(1)[523]. In this respect, it should be recalled that 'other' and 'more burdensome' in Art. 24(1) concern two distinct situations (see supra, 2.B.VI). The prohibition of 'other' taxation, which is an expression of the equality principle, concerns the basis of charge, the method of assessment and the rate: these elements must be the same for nationals and foreigners. The prohibition of 'more burdensome' taxation, which is an expression of the non-discrimination principle, concerns the formalities connected with the taxation: these must not be more onerous for foreigners.

---

apportionment method. It is inherent in such a method that the profit calculation differs somewhat between PEs and resident taxpayers. The Court illustrates this by pointing out that the result may in some years be more and in other years less favourable, but that is not the core issue here. The underlying idea is that the Contracting States agreed to deviate from the PE non-discrimination standard by allowing for an application of an apportionment method. Even if the apportionment method were always to the detriment of PEs, Art. 24(3) would still be to no avail, as the States have agreed that this method is given preference over the provisions of Art. 24.

[520] Comm. OECD on Art. 24, para. 34. Some treaties, however, also prohibit taxation which is 'other or more burdensome', or 'other, higher or more burdensome'. See, for instance, Art. XIX(2) of the 1959 treaty between Germany and Egypt or Art. 20(2) of the 1987 treaty between Belgium and the USSR. This was also mentioned by Working Party no. 4 of the OEEC Fiscal Committee: *"The Working Party was also asked to mention in the official comments that to tax, for reasons of practical convenience, non-domiciled persons differently from domiciled persons does not constitute discrimination so long as this does not result in more burdensome taxation on the non-domiciled persons than on the others. The Working Party considers that the words 'shall not be less favourably assessed' give the right to apply such different taxation. But the States should limit their claims in this respect, by endeavouring not to resort to different taxation unless it is in keeping, not only with their own conceptions, but also with generally accepted standards"* (FC/WP4(57) 3, 12).

[521] The following addition to Comm. OECD on Art. 24, para. 34 has been proposed in OECD, "Revised Discussion Draft of a new Article 7 of the OECD Model Tax Convention", 24 November 2009 to 21 January 2010, 39: *"For example, paragraph 3 does not prevent the application of specific mechanisms that apply only for the purposes of determining the profits that are attributable to a permanent establishment. The paragraph must be read in the context of the Convention and, in particular, of paragraph 2 of Article 7 which provides that the profits attributable to the permanent establishment are those that a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions would have been expected to make. Clearly, rules or administrative practices that seek to determine the profits that are attributable to a permanent establishment on the basis required by paragraph 2 of Article 7 cannot be considered to violate paragraph 3, which is based on the same principle since it requires that the taxation on the permanent establishment be not less favourable than that levied on a domestic enterprise carrying on similar activities."*

[522] However, some treaties contain a reference to 'connected requirements' in their PE non-discrimination clause; for instance, Art. 24(2) of the 1959 treaty between Germany and the Netherlands or Art. 20(2) of the 1987 treaty between Belgium and the USSR.

[523] E.g. J. AVERY JONES, "The non-discrimination article in tax treaties: Part 2", *British Tax Review* 1991, 425; P. ADONNINO, o.c., 57; A. ZALASINSKI, "Article 24(1) of the OECD Model Convention and the exclusion of MFN treatment - a comment on the OECD public discussion draft", *Intertax* 2007, 466. The Comm. OECD also uses the expression "more burdensome" when interpreting Art. 24(3): see Comm. OECD on Art. 24, para. 34.

In Art. 24(3), only 'less favourable' treatment is prohibited, and this treatment only concerns the taxation itself (i.e. the basis of charge, the method of assessment and the rate). That has the following implications for the disadvantage-test:

- permanent establishments may be subject to **other** taxation, as long as this does not lead to **less favourable** taxation (i.e. less favourable basis of charge, method of assessment or tax rate);
- permanent establishments may be subject to **other** formalities, as long as this does not lead to **less favourable** taxation;
- permanent establishments may be subject to **less favourable** formalities, as long as this does not lead to **less favourable** taxation;
- States are allowed to grant permanent establishments **more favourable** treatment, both as regards **taxation** and as regards **formalities** (i.e. no prohibition of reverse discrimination)[524].

Even though it might seem counter-intuitive, the text of Art. 24(3) therefore does not preclude less favourable formalities being imposed on PEs, as long as this does not result in less favourable taxation.

One might think that the reason for this discrepancy is the link that exists in Art. 24(1) between, on the one hand, 'other' and 'taxation' and, on the other hand, between 'more burdensome' and 'connected requirements'. Because PEs are, by definition, different from residents, it was impossible to include the reference to 'other' treatment in Art. 24(3): for practical purposes, it may be necessary to tax (the PE of) a non-resident differently from a resident. As long as this different treatment does not lead to less favourable treatment, there is no discrimination. However, that does not explain why Art. 24(3) does not refer to 'connected requirements'.

If the disadvantage-test in Art. 24(1) is structured as follows[525]:

other ➔ taxation
less favourable ➔ formalities

And if it is impossible to prohibit 'other' taxation of PEs, then there is no reason why the disadvantage-test in Art. 24(3) should be structured as follows:

less favourable ➔ taxation

The more logical approach would be to prohibit both 'less favourable taxation' and 'less favourable formalities' in Art. 24(3). Put briefly, the specific nature of PEs only explains why it is not possible to prohibit 'other taxation' and 'other formalities'. It does not explain why Art. 24(3) does not prohibit 'less favourable formalities'.

Whatever the reason, this discrepancy between Art. 24(1) and Art. 24(3) – and, particularly, the absence of a prohibition of discrimination as regards formalities in Art. 24(3) – might lead to remarkable results. As an example, see the *Commerzbank*-case, discussed in 2.D.III.C.a.2. According to VOGEL, the fact that Art. 24(3) only refers to 'taxation' implies

[524] See also Comm. OECD on Art. 24, para. 14, which provides that Art. 24(1) does not preclude a State from granting foreigners certain concessions or facilities that are not available to its own nationals, *"for special reasons of its own, or in order to comply with a special stipulation in a double taxation convention, such as, notably, the requirement that profits of permanent establishments are to be taxed on the basis of separate accounts"* (see also supra, 2.B.VI.B).

[525] For the sake of clarity, I assume that 'more burdensome' in Art. 24(1) has the same meaning as 'less favourable' in Art. 24(3).

> that the provision is only aimed at the direct burden of tax, i.e. what must be paid in terms of money[526]. However, that approach might be too narrow. From a textual perspective, it seems more convincing that Art. 24(3) is aimed at all elements of the national tax system at which Art. 24(1) is aimed, apart from the formalities connected with the taxation (see also the *UBS*-case, discussed in 2.D.III.C.c.1).

The Commentary illustrates the implications of the disadvantage-test under Art. 24(3) by examining different aspects of the taxation of PEs (assessment of tax, structure and rate of tax, tax treatment of dividends received, withholding tax on dividends, interest and royalties, credit for foreign tax and the extension to PEs of the benefit of tax treaties concluded with third States)[527]. These different aspects will be addressed below.

a. Assessment of tax

The Commentary gives the following – non-exhaustive[528] – list of elements relating to the assessment of tax (i.e. determination of the taxable basis) to which the PE of a non-resident taxpayer is entitled under Art. 24(3)[529]:

1. The same right as resident taxpayers to deduct trading expenses from their taxable profits and the right to attribute to the PE a proportion of the overheads of the head office[530]. It is not permitted to impose other restrictions to these deductions than those also imposed on residents.

2. The same facilities with regard to depreciation (straight line depreciation, declining balance depreciation, but also special systems that exist in a number of countries, such as wholesale writing down, accelerated depreciation, etc.) and reserves. In respect of reserves, the Commentary notes that these are sometimes authorised for purposes other than the offsetting (in accordance with commercial accounting principles) of depreciation on assets, expenses or losses which have not yet occurred but which are likely to occur in the near future (e.g. in certain countries, enterprises are entitled to set aside, out of taxable profit, provisions or 'reserves' for investment). When such a right is enjoyed by resident enterprises, or resident enterprises in a specific sector of activity, it should also be enjoyed, under the same conditions, by non-residents with respect to the PE in that State, insofar as the activities to which such provisions or reserves would pertain are taxable in that State.

3. The same option of carrying forward or backward losses (possibly limited to a fixed period of time) on the business activities of the PE, as shown in its separate accounts[531].

4. The same rules concerning the taxation of capital gains realised on the alienation of assets, whether during or on the cessation of business.

---

[526] K. VOGEL, *o.c.*, 1316, No. 126.
[527] Comm. OECD on Art. 24, paras. 40-72.
[528] Comm. OECD on Art. 24, para. 43.
[529] Comm. OECD on Art. 24, para. 40.
[530] The reference to *"the right to attribute to the PE a proportion of the overheads of the head office"* is deleted in OECD, "Revised Discussion Draft of a new Article 7 of the OECD Model Tax Convention", 24 November 2009 to 21 January 2010, 39.
[531] The reference to separate accounts is deleted in OECD, "Revised Discussion Draft of a new Article 7 of the OECD Model Tax Convention", 24 November 2009 to 21 January 2010, 39.

The general idea in the Commentary is that Art. 24(3) only concerns the taxation of the PE's own activities. As a result, the prohibition of discrimination does not extend to rules that take account of the relationship between a domestic enterprise (to which the PE is compared) and other enterprises, e.g. rules that allow consolidation, transfer of losses or tax-free transfers of property between companies under common ownership. Such rules do not focus on that domestic taxpayer's own business activities, but on the taxation of that taxpayer as part of a group of associated enterprises (for instance to ensure or facilitate tax compliance and administration within a domestic group)[532].

While it is true that Art. 24(3) is only concerned with the PE's own activities (see supra), the Commentary's position should be nuanced in my opinion. It cannot be said *a priori* that all domestic measures on group treatment fall outside the scope of Art. 24(3). Instead, it should be ascertained in each case whether the PE is treated less favourably than a resident enterprise. In other words, if the PE itself incurs a disadvantage as compared to a resident enterprise, there is discrimination, even if the measure at issue forms part of the domestic group taxation regime. Consider, for instance, that State A has a domestic rule that allows the transfer of losses between resident companies under common ownership. The taxpayer is a State B resident with a PE in State A and a subsidiary in State A. If the PE is not entitled to engage in a loss transfer with the State A subsidiary, it is clear that the PE itself is less favourably treated than a resident company. Clearly, by not being able to transfer the losses, the PE suffers a disadvantage. That is "less favourable taxation on the PE", as required by Art. 24(3). By excluding all measures that take account of the relationship between domestic measures, the Commentary unduly restricts the scope of application of Art. 24(3)[533].

The Commentary also states that the application of transfer pricing rules based on the arm's length standard in the case of transfers from a PE to its head office or *vice versa* cannot be considered to violate Art. 24(3), even if those rules do not apply to transfers within a domestic enterprise. The reason is that the application of the arm's length standard to the determination of the profits attributable to a PE is mandated by Art. 7(2) OECD MC, and that provision forms part of the context in which Art. 24(3) must be read[534]. The Commentary also notes that Art. 9 authorizes the application of the arm's length standard to a transfer between a domestic enterprise and a foreign related enterprise. Therefore, one cannot consider that its application in the case of a PE results in less favourable taxation than that levied on a domestic enterprise[535].

The Commentary further provides that difficulties may arise in respect of tax incentives (tax exemptions, reductions, etc.) relating to the decentralisation of industry, the development of economically backward regions or the promotion of new activities necessary for the expansion of the economy. As these measures are aimed at objectives directly related to "the economic activity proper of the State", they should be extended to non-residents' PEs under Art. 24(3) once they have been accorded the right to engage in business activity in that State (either under national law or under an international agreement). However, these non-residents must fulfill the same conditions and requirements as residents. Accordingly, the benefits may be denied if the PE is unable or refuses to fulfill these conditions or requirements.

---

532 Comm. OECD on Art. 24, para. 41.
533 For a similar issue under Art. 24(5), see 2.F.I.B.b.
534 See also 2.B.VI.D.b and 2.D.III.C.e , on situations where discrimination is caused by tax treaty provisions.
535 Comm. OECD on Art. 24, para. 42.

Finally, the Commentary observes that Art. 24(3) does not entitle non-residents to tax advantages attaching to activities the exercise of which is strictly reserved to residents (on grounds of national interest, defence, protection of the national economy, etc.), since non-residents are not allowed to engage in such activities. Similarly, the Commentary notes that Art. 24(3) does not require a State to extend special tax priviliges granted to non-profit institutions whose activities are performed for purposes of public benefit that are specific to that State, to permanent establishments of similar institutions of the other State, whose activities are not exclusively for the former State's public benefit[536].

b. Structure and rate of tax

1. Progressive scales and the non-resident's worldwide profits

The Commentary provides that, when the taxation of profits of resident companies is calculated according to a progressive scale, such a scale should in principle also be applied to PEs in that State. The Commentary further notes that it is not contrary to Art. 24(3) for the PE-State, in applying the progressive scale, to take into account the profits of the whole company of which the PE forms part, since resident companies are in fact treated in the same way[537]. When such a progressive system includes a rule that a minimum rate is applicable to PEs, it cannot be claimed *a priori* that such a rule is contrary to Art. 24(3). According to the Commentary, the profits of the whole enterprise of which the PE forms part should be taken into account in determining the rate applicable according to the progressive scale. Only if the minimum rate is higher, has Art. 24(3) been breached[538].

However, even if the profits of the whole enterprise are taken into account when applying either a progressive scale or a minimum rate, the Commentary notes that this should not conflict with the principle that the profits of the PE must be determined under Art. 7(2), as if it were a distinct and separate enterprise. Therefore, the minimum amount of the tax levied in the PE State is the amount which would have been due if it were a distinct and separate enterprise, without reference to the profits of the whole enterprise of which it forms part. Accordingly, the PE State is allowed to apply the progressive scale applicable to resident enterprises solely to the profits of the PE, leaving aside the profits of the whole enterprise when the latter are less than those of the PE. Likewise, the PE State may tax the profits of the PE at a minimum rate, provided that the same rate applies also to resident enterprises, even if taking into account the profits of the whole enterprise would result in a lower amount of tax, or no tax at all[539].

---

[536] Comm. OECD on Art. 24, paras. 43-47. See also Comm. OECD on Art. 24, paras. 10-13, already discussed in 2.B.VIII. The requirement that the activities of PEs of similar institutions of the other Contracting State must be exclusively for the public benefit of the PE State seems incorrect. It is possible that a non-profit institution carries out activities for the benefit of both the PE State and the other Contracting State. From that perspective, it would be incorrect to deny the benefits altogether in the PE State. A more realistic approach would be to require that the PE pursues activities that are recognized by the PE State as being charitable (as the ECJ does when comparing charities of different Member States: see Part III, 2.E.I.A.b.10). See also the remarks made by the Tax Faculty of the Institute of Chartered Accountants in England and Wales on 5 July 2007 in respect of the OECD Discussion Draft on Art. 24: *"We consider that charitable activities carried on in State B by a charity resident in State A must be of public benefit to State B and should be eligible for the same tax reliefs as are available to a charity resident in State B carrying on the same activities"* (para. 48).

[537] Comm. OECD on Art. 24, para. 56, referring to Comm. OECD on Art. 23, paras. 55, 56 and 79.

[538] Comm. OECD on Art. 24, para. 57.

[539] Comm. OECD on Art. 24, para. 58. Germany does not agree with this interpretation; see the observation in Comm. OECD on Art. 24, para. 82: *"The interpretation given in paragraphs 57 and 58 above is not endorsed by*

The question whether, and to what extent, the profits of the whole enterprise can be taken into account in the PE State was also discussed by the Working Group in the context of the 2007 Public Discussion Draft[540]. According to the Working Group, these issues were already addressed in paragraphs 56 to 58 of the Commentary on Art. 24 (discussed above), *"which recognise that paragraph 3 allows the State where the permanent establishment is located to take account of the overall profits of the enterprise in determining the rate at which the profits of the permanent establishment should be taxed."* However, a minority opinion was that this conclusion appeared to conflict with the Working Group's earlier conclusion that Art. 24(3) refers to taxation on the activities of the PE, not to taxation of the foreign enterprise as a whole (see supra). The Discussion Draft continues: *"The Group discussed extensively whether such conflict existed. Many delegates considered that paragraphs [56-58] were a logical extension of the principle of exemption with progression recognized in Article 23 on elimination of double taxation: in determining the tax rate applicable to the profits of a permanent establishment, it was logical to take account of the overall ability to pay of a taxpayer, which could only be determined by taking account of the overall income of that taxpayer. That did not mean, however, that taxation was then applied to profits not attributable to the permanent establishment."*

Two specific examples are then given in order to illustrate the existing practice in different States. First, if a taxpayer has two or more PEs in a country, most countries aggregate the profits of these PEs for purposes of taxation, thereby taking account of at least some other profits of the foreign enterprise in determining the rate applicable for the taxation on a single PE. Secondly, many countries similarly aggregate the PE profits with those profits that are taxable without limitation under other Articles (e.g. Article 17) for the purpose of determining the applicable rate.

Considered solely from the perspective of non-discrimination, this approach is not problematic: there is no discrimination when the PE State takes account of the worldwide profits of the non-resident taxpayer when applying the progressive scale to that taxpayer's PE, if it does the same for resident taxpayers. However, it is difficult to reconcile this approach with the separate entity-approach underlying Art. 24(3) and with the general idea underlying tax treaties. So either the PE is considered as a separate entity – in which case it is not appropriate to take account of the non-resident's worldwide profits – or it is not considered as a separate entity – in which case Art. 24(3) would require that other facilities concerning worldwide profits to be applied to the PE as they are applied to residents (e.g. the taking into account of foreign losses).

Art. 23(A)(3) provides: *"Where in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital"*[541]. Consequently, when the residence State is required to exempt income pursuant to the provisions of a tax treaty, it may nevertheless include the exempted income when calculating the amount of tax due on the remaining income. According to the Commentary, this principle applies to income

Germany, the tax laws of which require the application of a minimum rate on exclusively inbound sources with respect to non-residents; the minimum rate is close to the lower end of the progressive tax scale."

540 OECD, "Application and interpretation of Article 24 (non-discrimination). Public discussion draft", 3 May 2007, 65-70.

541 See also Art. 23(B)(2) OECD MC and the accompanying Comm. OECD on Art. 23, para. 79.

or capital exempted by virtue of Art. 23(A)(1) as well as to income or capital which under any other provision of the treaty *"shall be taxable only"* in the other Contracting State. This is the reason why, in the 1977 OECD MC, the principle of progression was transferred from Art. 23(A)(1) to a new Art. 23(A)(3), and reference was made to exemption *"in accordance with any provision of the Convention"*[542].

Remarkably, the Commentary then observes that Art. 23(A)(3) *"relates only to the State of residence. The form of the Article does not prejudice the application by the State of source of the provisions of its domestic laws concerning the progression"*[543]. This seems to imply that the source State, when it is required to exempt items of income that are exclusively taxable in the residence State, may nevertheless take that exempted income into account when calculating the amount of tax due on other items of income, which it may tax under the treaty.

For instance, in a 1999 case before the Brussels Court of Appeal, a Swiss resident received income from immovable property situated in Belgium and pension payments from a Belgian source[544]. The income from immovable property was taxable in Belgium, but the pension was only taxable in Switzerland under the Belgian/Swiss tax treaty. When assessing the taxpayer on the income from immovable property, the Belgian tax authorities took the pension payments into account in the application of the progressive scale (exemption with progression)[545]. According to the taxpayer, this was contrary to Art. 24(1) of the treaty, the provision on the elimination of double taxation in Belgium[546]. In particular, the taxpayer argued that the treaty only allowed the **residence State** (i.e. Switzerland) to apply the method of exemption with progression.

The Court of Appeal decided in favour of the tax authorities. According to the Court, Art. 24(1) of the treaty only concerned the situation where a Belgian resident received income that was taxable in Switzerland. This provision did not say anything about whether Belgium, when it taxed a Swiss resident in its capacity as source State, could apply the exemption with progression. The Court held that it was impossible to infer from the silence of the treaty provision an implicit prohibition for the source State to apply the exemption with progression.

---

[542] Comm. OECD on Art. 23, para. 55. In the 1963 OECD Draft Convention, Art. 23(A)(1) read as follows: *"Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraph 2, exempt such income or capital from tax* ***but may, in calculating tax on the remaining income or capital of that person, apply the rate of tax which would have been applicable if the exempted income or capital had not been so exempted****"* (emphasis added).

[543] This issue was addressed in more detail in the 1963 Comm. OECD on Art. 23, paras. 35-36: *"The provision concerning progression, proposed in the Article, relates only to the State of residence. A question arises, however, when a State of source which applies a progressive tax scale gives up the right to tax and the non-resident taxpayer derives other income from that State. Different principles may be applied by a State of source in determining its progression. Its internal tax law may provide for the calculation of the progression on the global income of the taxpayer or only on the total income arising to the taxpayer in the State of source. The form of the Article does not prejudice the application by the State of source of the provisions of its national legislation concerning the progression. If two Contracting States wish to clarify whether, or to what extent, the State of source shall have the right to use a progression they are left free to do so in bilateral negotiations."*

[544] Brussels Court of Appeal, 5 February 1999, *J.D.F.* 1999, 54-59.

[545] Art. 87quater ITC 1964 provided that income that was exempt under a tax treaty was taken into account in the calculation of the amount of tax due. This provision did not distinguish between exempted income sourced in Belgium and exempted income sourced abroad. Art. 152(1) ITC 1964 provided that the tax due by non-resident individual taxpayers was calculated in the same way as for resident individuals. As a result, the method of progression with exemption also applied to non-residents.

[546] Art. 24(1) of the 1978 treaty between Belgium and Switzerland, which is identical to Art. 23(A)(1) of the 1963 OECD Draft Convention.

Therefore, as the treaty did not address this matter, the issue had to be resolved under domestic law (which, as pointed out earlier, allowed Belgium to apply the exemption with progression)[547].

This conclusion is in line with the position taken by the Commentary (see supra). Nevertheless, this approach is not entirely convincing[548]. The gist of the argument seems to be that Art. 23 does not say anything about the source State, with the result that that State is free to apply exemption with progression. However, that is beside the point. The basic idea underlying tax treaties is that international taxation is founded on the distinction between unlimited residence-based taxation and limited source-based taxation. A State normally subjects its residents to tax on their worldwide income, while taxing non-residents on their income sourced in that State. Both these mechanisms are attenuated in tax treaties in order to avoid double taxation. Accordingly, the distributive rules in tax treaties provide that States should refrain from taxing certain items of income, sometimes in their capacity as source State, sometimes in their capacity as residence State. These provisions thus preclude the States from including the elements in question in the tax base. However, the treaty is not intended to affect other aspects of domestic law, such as the applicable tax rate (leaving aside the limitation that may be imposed on withholding tax rates). As a result, the residence State is still entitled to take account of the worldwide income of its residents when calculating the applicable tax rate. By contrast, the source State did not include foreign items of income in the tax base to begin with, so there is no reason to assume that the tax treaty grants the source State the right to calculate the tax rate on the non-resident's worldwide income. This would run counter to the basic distinction in international tax law between unlimited residence-based taxation and limited source-based taxation, and would increase the possibility of double taxation (as it would allow both the residence State and the source State to apply progression)[549].

[547] *"[Art. 24(1)] ne règle que l'hypothèse où un résident de la Belgique perçoit des revenus qui sont imposables dans l'Etat de la source. Cette disposition est muette quant au droit de l'Etat de la source d'appliquer la réserve de progressivité lorsque celui-ci taxe les revenus d'origine belge d'un résident de la Suisse. On ne peut pas […] déduire du silence du texte l'existence d'une interdiction implicite pour l'Etat de la source d'appliquer la réserve de progressivité. L'application d'une réserve de progressivité dans ce cas précis n'est pas réglée par la convention et relève donc exclusivement du droit interne."*

[548] *Contra*: Cass. 30 June 1994, *Lescure*, No. AR F.93.0077.F, *F.J.F.* 1994, 385; V. KLUGE, *Das Internationale Steuerrecht – 4. Auflage*, München, Beck, 2000, 934-935; M. HELMINEN, "Dual residence conflicts and the elimination of double taxation in Finland", *B.I.F.D.* 2002, 161.

[549] See also K. VOGEL, *On Double Taxation Conventions*, 1261, who reaches the same conclusion on the basis of a different argument. He starts from the position that the proviso safeguarding progression in Art. 23(A)(3) only clarifies what would apply even if there was no such express proviso. In other words, the residence State is allowed to take account of its residents' worldwide income in calculating the tax rate, even where no express provision to that effect is included in the treaty. On the other hand, the situation is different where a treaty does contain an express provision allowing the State to apply progression, but where the contents of that provision only relate to specific items of income or capital while not extending to others. In such a case, any item of income or capital not expressly covered by the provision may not be taken into account for the purpose of calculating the tax rate (*"an express proviso by defining its scope, at the same time limits its scope"*). This was the reason why, in the 1977 OECD MC, the principle of progression was transferred from Art. 23(A)(1) to a new Art. 23(A)(3): until 1977, items of income or capital exempted in the residence State by virtue of a distributive rule of the treaty, rather than by virtue of Art. 23, could not be taken into account when calculating the tax rate (see supra). However, items of income that are exempt by virtue of distributive rules of the treaty **in the source State** are not covered by this express provision. As a result, VOGEL argues that where the treaty provision concerning exemption with progression follows Art. 23(A)(3) OECD MC, the source State cannot apply an exemption with progression. If I understand this line of reasoning correctly, this would imply that the source State is able to apply progression if the treaty does not contain an express provision dealing with this issue: if there is no express provision, the source State's possibility to apply progression is not limited. However, this would run counter to the fundamental idea that source States are not entitled to take account of items of income

2. Tax-free thresholds

The question whether a tax-free threshold provided for in domestic law should be applied to the PE of a non-resident taxpayer should be answered against the backdrop of the second sentence of Art. 24(3) (*"This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents"*). Consequently, where the domestic law of the PE State makes the tax-free threshold dependent on taxpayers' personal and family circumstances, it should not be extended to non-residents. Conversely, where the tax-free threshold applies regardless of such circumstances, Art. 24(3) requires the PE State to extend the benefit of the threshold to the PE.

In the 2007 Discussion Draft, two examples are given to illustrate this distinction[550]. First, where a fixed tax-free threshold is granted to individuals with dependent children, the second sentence of Art. 24(3) prevents this benefit from being extended to the PE of a non-resident. In the second example, the domestic law of the PE State provides that the tax rate on the first 10,000 of income of a resident individual taxpayer is 0%, 20% on the next 15,000 of income and 35% on the remaining income is 35%. The uniform rate applicable to non-resident individuals is 25%. As the tax-free threshold here is related to the amount of income and not to the taxpayer's personal and family circumstances, it is not covered by the second sentence of Art. 24(3). According to the Discussion Draft, a non-resident with a PE in that State to which 5,000 of profits can be attributed and who has 30,000 of other foreign income cannot invoke Art. 24(3) to claim that he should not pay any tax in the PE State (on the basis that the first 10,000 of income is tax-free for residents). However, Art. 24(3) *"would require the application of the domestic tax rates to that individual. The applicable rate would then be determined by taking into account the worldwide income. In the above example, that would mean that since the taxpayer would pay tax of 6,500 if he were a resident, the maximum rate applicable under paragraph 3 is 18.57% (i.e. 6 500/35 000)."*

I do not find this line of reasoning entirely convincing. The subject of comparison here is a non-resident taxpayer with a PE to which 5,000 of profits can be attributed. In the PE State, he is taxed at a rate of 25% on this income, resulting in a tax burden of 1,250. The object of comparison is a resident taxpayer carrying on the same activities. If such a resident taxpayer realised a profit of 5,000 in his State of residence, he would not be taxed on this income, given the tax-free threshold of 10,000. Consequently, the PE is treated less favourably than a resident enterprise carrying on the same activities, because of the applicability of the tax-free threshold to the latter taxpayer. As this threshold does not depend on personal and family circumstances, the second sentence of Art. 24(3) does not apply. Therefore, the tax-free threshold should be extended to the PE, resulting in an exemption from tax in respect of the profit of 5,000 attributable to the PE. There is no reason to take account of the non-resident's worldwide income in applying the progressive scales. As mentioned earlier, this approach is questionable, given the separate entity-approach on which Art. 24(3) is based.

---

exceeding their limited tax jurisdiction. I do not see why the absence of a provision dealing with progression in the residence State would allow the source State to take account of a non-resident taxpayer's worldwide income.

[550] OECD, "Application and interpretation of Article 24 (non-discrimination). Public discussion draft", 3 May 2007, 71.

3. Special taxes on a non-resident's PE

The Commentary further stresses that a PE, by its nature, does not distribute dividends. Accordingly, tax aspects concerning the treatment of profit distributions fall outside the scope of Art. 24(3): its scope is restricted to the taxation of the profits from the activities of the PE itself and does not extend to the taxation of the enterprise as a whole. Consequently, issues related to domestic systems for the integration of the corporate and shareholder's taxes (e.g. advance corporation tax, précompte mobilier, franked income, etc.) fall outside the scope of Art. 24(3)[551].

This fundamental difference between PEs and resident taxpayers explains why some States tax the profits of a non-resident's PE at a higher rate than the profits of residents. This additional tax, sometimes referred to as a 'branch profits tax' is levied because if a subsidiary of the non-resident earned the same profits as the PE and subsequently distributed these profits as a dividend, an additional tax would be levied on this dividend (in accordance with Art. 10(2) OECD MC). The Commentary states that, where such a branch tax is simply expressed as an additional tax payable on the profits of the PE, it must be considered as a tax levied on the profits of the activities of the PE itself and not as a tax on the non-resident taxpayer to which the PE belongs. Even though the branch tax on the PE may be equivalent to the withholding tax levied on distributions made by a subsidiary of a non-resident, the PE is nevertheless discriminated against because the withholding tax is not a tax on the distributing company but on its shareholders. Such a branch tax would therefore be contrary to Art. 24(3) because the PE is treated less favourably than a resident taxpayer.

> As an example, consider the U.S. branch profits tax of § 884(a) I.R.C., which tries to equate the taxation of a non-resident's branch with that of a non-resident's subsidiary by levying a tax in addition to the general corporate tax[552]. The branch profits tax is, in principle, only assessed when profits are not retained for business use within the branch. In doing so, the measure attempts to tax remittances to the head office of the PE, analogously to the taxation of dividend distributions by a resident subsidiary to its non-resident parent[553].
>
> Pursuant to § 884(e)(1), the branch profits tax will not be imposed if it conflicts with the provisions of a tax treaty (on the condition that the non-resident taxpayer is a 'qualifying resident' of the other Contracting State[554], i.e. if there is no treaty shopping[555]).

---

551 Comm. OECD on Art. 24, para. 59. For a thorough analysis of the application of Art. 24(3) to an imputation system, see the *UBS*-case, discussed in 2.D.II.B.b.3.

552 Obviously, issues concerning Art. 24(3) only arise in this context (and in the context of the U.S. branch interest tax, discussed hereafter) if the non-resident's presence in the U.S. meets the necessary threshold to constitute a PE.

553 In effect, the objective of the branch profits tax is to subject the income earned by non-resident companies operating in the U.S. to two levels of taxation, just like income earned and distributed by U.S. companies. In the latter case, the income is subject to a maximum marginal tax rate of 35% when it is earned and a maximum 30% tax when the company distributes dividends. In the case of a non-resident company, income is subject to the marginal rate of maximum 35% when earned and an additional branch profits tax of 30% is imposed when the income is repatriated (or deemed repatriated, because it is not reinvested in U.S. assets).

554 As a general rule, the term 'qualified resident' refers to a resident of the other Contracting State unless 50% or more of its stock is owned by third State residents or 50% or more of its income is used (directly or indirectly) to meet liabilities to third State residents. Companies whose stock (or whose parent's stock) is publicly traded on an established securities market in the other Contracting State are automatically treated as qualified residents.

555 This is an interesting nuance. It could be argued that the addition of the condition that the taxpayer is not treaty shopping constitutes discrimination, because no similar limitation applies to resident taxpayers. Moreover, it may be inappropriate to subject the applicability of the non-discrimination clause to the condition that there is

> Moreover, the IRS has recognized that the imposition of this tax constitutes discrimination contrary to Art. 24(3) and has given a list of tax treaties that prevent the application of the tax[556] [557]. It has been argued that tax treaties that do not contain a PE non-discrimination clause also preclude the application of the branch profits tax, on the basis of the nationality non-discrimination clause[558]. However, this is inconsistent with the conclusion reached earlier, that Art. 24(1) does not offer protection against discrimination on the basis of residence (see supra, 2.B). As residents and non-residents are not in the same circumstances for purposes of Art. 24(1), there is nothing to prevent the branch profits tax from being applied where the treaty only contains a nationality non-discrimination clause.

The situation is different, however, where a tax is imposed on amounts deducted – for instance as interest – in computing the profits of the PE. In that case, the tax is not levied on the PE itself, but on the enterprise to which the interest is considered to be paid. As a result, that tax is outside the scope of Art. 24(3)[559]. Depending on the circumstances, other provisions may be relevant in determining whether such a tax is compatible with the treaty (e.g. Articles 7 and 11)[560].

---

no abuse. As will be argued in 2.E.IV, Art. 24 OECD MC is not intended to counter abuse. There are specific tax treaty provisions to prevent abusive behaviour. If those provisions do not deny the taxpayer access to the treaty benefits, there is no reason to dismiss his claim under Art. 24 on the ground that the transaction constituted abuse.

[556] Treas. Reg. § 1.884-1(g)(3). See, however, the Reservation of the U.S. on Art. 24 in Comm. OECD on Art. 24, para. 87 (*"The United States reserves its right to apply its branch tax"*) and the positions of non-member countries Argentina (*"Argentina reserves the right to apply a branch profits tax"*) and Morocco (*"Morocco reserves the right to add a paragraph stating that nothing in this article can be interpreted as prohibiting Morocco to apply its branch tax […]"*). In its post-1986 treaties, i.e. the treaties concluded after the introduction of the branch profits tax, the U.S. has generally preserved the right to impose the tax in the treaty provisions themselves. Similarly, the 2006 U.S. Model Convention expressly allows for the application of a branch profits tax in Art. 10(8): *"A company that is a resident of one of the States and that has a permanent establishment in the other State […] may be subject in that other State to a tax in addition to the tax allowable under the other provisions of this Convention. Such tax, however, may be imposed on only the portion of the business profits of the company attributable to the permanent establishment […] that, in the case of the United States, represents the dividend equivalent amount of such profits […]"*. The dividend equivalent amount for any year approximates the dividend that a U.S. branch would have paid during the year if it had been operated as a separate U.S. subsidiary. The non-discrimination provision of the U.S. Model Convention provides that *"nothing in this Article shall be construed as preventing either Contracting State from imposing a tax as described in paragraph 8 of Article 10 (Dividends)"* (Art. 24(6) 2006 U.S. MC). Consequently, tax treaties concluded on the basis of the U.S. MC would not preclude the application of the U.S. branch profits tax.

[557] See also the position of U.S. Congress: *"Although Congress generally believed that a branch profits tax does not unfairly discriminate against foreign corporations because it treats foreign corporations and their shareholders together no worse than U.S. corporations and their shareholders, it understood that most treaty nondiscrimination articles relating to permanent establishments arguably operate to consider corporations and their shareholders separately in determining whether discriminatory tax rules exist. Congress generally did not intend to override U.S. income tax treaty obligations that arguably prohibit imposition of the branch profits tax even though as later-enacted legislation the Act's branch tax provisions normally would do so. Congress adopted this position, however, only on the understanding that the Treasury Department will renegotiate outstanding treaties that prohibit imposition of the tax"* (Joint Committee On Taxation, "General Explanation of the Tax Reform Act of 1986", H.R. 3838, 99th Congress, 1038).

[558] R. HAMMER and W. ROHRER, "U.S. branch taxation: a venture into the unknown", *B.I.F.D.* 1987, 7-8.

[559] In contrast, such a tax would most likely be contrary to the European freedoms; see the discussion of C-307/97, *Saint-Gobain* in Part III, 2.E.I.A.a.1.e and J. AVERY JONES and C. BOBBETT, "Interpretation of the non-discrimination article of the OECD Model", *B.I.F.D.* 2008, 52.

[560] Comm. OECD on Art. 24, para. 60-61. The relationship between such taxes, for instance the U.S. branch interest tax and excess interest tax, and Articles 7 and 11 will not be addressed here.

As an example, consider the U.S. branch interest tax of § 884(f) I.R.C., which treats interest that is paid by a U.S. branch as if it were paid by a resident corporation[561]. Accordingly, it will be deemed to be U.S. sourced interest, subject to tax there. According to a Treasury Regulation dealing with this issue, interest is 'paid by' the branch if it arises in connection with a liability that is identified in the non-resident taxpayer's books and financial statements as a liability of the U.S. business or is secured by U.S. assets[562]. As this interest is actually paid, and a resident taxpayer would be required to withhold U.S. tax on such interest, this provision does not seem to violate Art. 24(3).

Additionally, a special rule applies where the amount of the interest 'paid by' the branch under § 884(f) I.R.C. is less than the amount of interest expense deduction allocated to the branch in accordance with the domestic rules thereon[563] ('excess interest tax'). In such a case, the non-resident taxpayer must pay tax on the difference between the interest that is 'paid by' the branch and the interested that is allocated to (and deducted by) the branch, as if the difference were paid to the non-resident by a U.S. subsidiary[564]. The idea behing this provision is that the U.S. should be able to claim taxing jurisdiction over the amount of interest that is being deducted from the effectively connected corporate tax base. If the non-resident had invested in the U.S. through a U.S. subsidiary, any interest paid by that subsidiary would have been deductible from the corporate tax base but would have been subject to tax in the hands of the recipient. § 884(f)(1)(B) reaches a similar result by treating the non-resident taxpayer as the deemed recipient of the excess allocated interest that has been deducted in determining the amount of the effectively connected branch income[565]. In other words, the excess interest is treated as interest paid by the U.S. branch to the head office and a tax is applied at the rate that would have been applicable if the excess interest had actually been paid by a U.S. resident company. § 884(f)(3) addresses the relationship to tax treaties and provides for rules similar to those applicable to the branch profits tax (see supra). Accordingly, if the non-resident taxpayer is a 'qualified resident' of the other Contracting State, then either no tax or a reduced rate will be applied[566].

---

561 § 884(f)(1) I.R.C.: *"In the case of a foreign corporation engaged in a trade or business in the United States (or having gross income treated as effectively connected with the conduct of a trade or business in the United States), for purposes of this subtitle (A) any interest paid by such trade or business in the United States shall be treated as if it were paid by a domestic corporation, and (B) to the extent that the allocable interest exceeds the interest described in subparagraph (A), such foreign corporation shall be liable for tax under section 881 (a) in the same manner as if such excess were interest paid to such foreign corporation by a wholly owned domestic corporation on the last day of such foreign corporation's taxable year."* Allocable interest is defined in § 884(f)(2) I.R.C. as *"any interest which is allocable to income which is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States."*

562 Treas. Reg. § 1.884-4(b)(1) and IRS Notice 87-56, 1987-2 *C.B.* 367.

563 Under the U.S. system of taxing branches of foreign corporations, the branch is able to deduct a portion of the interest paid by the entire corporation ('allocable interest'). The deductible portion is determined under a formula that generally allocates the entire interest paid by the corporation among all of its branches and its head office in proportion to the assets of each (see Treas. Reg. § 1.882-5).

564 As an example: a U.S. branch books and pays 100 interest to a non-resident bank. That amount of 100 would be treated as U.S. source interest and the U.S. branch would be required to withhold U.S. tax (branch interest tax: § 884(f) I.R.C.). Suppose that under the applicable U.S. rules (Treas. Reg. § 1.882-5), the amount of interest expense allocated to the branch in calculating its effectively connected income is 150. The 50 of 'excess interest' is then deemed to have been received by the non-resident taxpayer (i.e. the head office of the PE) as U.S. source interest. The branch is therefore required to withhold U.S. tax on this excess interest. As a result, all interest expense that was deducted for purposes of determining the effectively connected income of the branch has been subject to U.S. tax as U.S. source interest income (the example is taken from P. McDANIEL, H. AULT and J. REPETTI, *Introduction to United States International Taxation*, The Hague, Kluwer Law International, 2005, 76-77).

565 P. McDANIEL, H. AULT and J. REPETTI, *Introduction to United States International Taxation*, The Hague, Kluwer Law International, 2005, 76.

566 In addition, if the non-resident taxpayer is not a qualified resident of the other contracting State but pays interest to a resident of a third State, the recipient of the interest will be taxed in accordance with the provisions

According to the IRS, the excess interest tax is not contrary to the PE non-discrimination provision in tax treaty, because that provision *"does not require structural or mechanical identity between the methods used to determine the United States tax liability of such foreign and domestic corporations, respectively, so long as the net result of such methods is approximately the same, i.e., the tax burden imposed on a foreign corporation in respect of its United States permanent establishment approximates the tax burden that is imposed on an enterprise of the United States engaged in the same activities"*[567]. Consequently, there is no discrimination because the overall tax treatment is similar to that of the payment of interest by a U.S. subsidiary to its foreign parent: the purpose of § 884(f)(1)(B) *"is to treat the interest expense of a foreign corporation doing business through a U.S. branch in approximately the same manner as the interest expense of a wholly-owned domestic subsidiary of a foreign corporation […]. This treatment recognizes that excess interest with respect to a branch is the functional equivalent of interest paid on parent debt funding with respect to a subsidiary"*.

It has been suggested that this is the wrong comparison: instead of comparing the PE to a U.S. subsidiary paying interest to a foreign parent, it should be compared to a U.S. subsidiary paying interest to a U.S. parent. In the latter case, there would be discrimination as the U.S. subsidiary would not withhold tax (there is no withholding tax on payments made to U.S. domestic corporations). This argument is supported by referring to Art. 24(4) OECD MC, under which the comparison is made between interest paid by a resident to a non-resident and interest paid by a resident to another resident (see infra)[568]. Consequently, the question as to the compatibility of the excess interest tax with Art. 24(3) depends on whether the comparison is made with a U.S. resident paying interest to another U.S. resident or with a U.S. resident paying interest to a non-resident[569].

In my opinion, the comparison made by the IRS is the correct one: Art. 24(3) OECD MC ensures that the PE is not treated less favourably than a resident carrying on the same activities. Therefore, a PE 'paying' interest to a non-resident (its head office) should not be treated less favourably than a resident paying interest to a non-resident. From this perspective, the excess interest tax is not discrminatory[570]. Only where the PE 'pays' interest to a resident, should it be compared to a resident paying interest to another resident. Art. 24(4) serves a fundamentally different purpose and therefore requires a different comparison. As a result, the analogy does not hold.

of the treaty between the U.S. and that third State (assuming that the recipient is a qualified resident of the third State); see § 884(f)(3)(B).

[567] IRS Notice 89-80, 6 July 1989, 1989-2 *C.B.* 394.

[568] S. GOLDBERG and P. GLICKLICH, "Treaty-based nondiscrimination: now you see it now you don't", *Florida Tax Review* 1992, 97. See also P. GLICKLICH and S. GOLDBERG, "United States", in IFA, *Non-discrimination rules in international taxation. Cahiers de droit fiscal international,* Vol. LXXVIIIb, Amersfoort, Sdu Fiscale & Financiële Uitgevers, 1993, 726; R. HAMMER and W. ROHRER, "U.S. branch taxation: a venture into the unknown", *B.I.F.D.* 1987, 9.

[569] The argument that the excess interest tax under § 884(f)(1)(B) discriminated against non-residents' permanent establishments was raised in U.S. Tax Court, 25 June 1997, *Taiyo Hawaii Company, Ltd v CIR*, 108 *T.C.* 590. Unfortunately, the Tax Court did not address the issue because the taxpayer had not raised this argument in a timely manner.

[570] Whether it is consistent with the tax treaty to apply withholding taxes on interest payments between PE and head office will not be addressed here. That is a matter of Article 7 OECD MC, which goes beyond the scope of this study.

c. Dividends received in respect of holdings owned by a PE

The Commentary is not entirely conclusive on this issue[571]. First, reference is made to special domestic rules for the taxation of dividends distributed between companies, intended to alleviate double taxation (e.g. the ‘Schachtelprivileg’ in Germany). According to the Commentary, opinions differ as to whether the benefits of these domestic rules should be extend to PEs in respect of dividends on holdings forming part of their assets.

On the one hand, some States argue that these domestic rules should be extended to PEs on the basis of Art. 24(3). The purpose of these rules is to avoid double taxation on profits made by a subsidiary and distributed to a parent company. Profits tax should be levied once, in the hands of the subsidiary performing the profit generating activity. Consequently, when the parent company receives such profits when distributed by the subsidiary, it should be exempted from tax or be given relief for the taxation borne by the subsidiary. The same reasoning applies where a PE holds shares as direct investment, with the result that such a PE should be granted the benefit of the domestic rules, given the fact that the profits have already been taxed in the hands of the subsidiary. According to the Commentary, it is unlikely that the State where the head office is situated would give relief for the double taxation brought about by the levying of a second tax in the hands of the PE. Therefore, the benefits of the domestic rules should be extended to the PE (on the condition that the shares in question are effectivily connected with the activity of the PE and that the profits out of which the dividends are distributed have borne a profits tax).

Conversely, other States take the position that Art. 24(3) does not require such an extension of the domestic rules. Several reasons are given to justify this position. First, the purpose of these domestic rules is to avoid economic double taxation of dividends, and it should be for the recipient company’s State of residence (and not the PE State) to bear its cost, because that State is more interested in the aim in view. Secondly, the loss of tax revenue incurred by a State in applying these domestic rules is partly offset by the taxation of the dividends when they are subsequently redistributed by the parent company. A State which extended the benefit of its domestic regime to PEs would not be compensated by a subsequent taxation. Thirdly, when the domestic regime is made conditional upon redistribution of the dividends, it should not be extended to PEs, as a PE does not distribute dividends and would therefore be treated more favourably than a resident company. Finally, there is a risk that companies of one State might transfer their holdings in companies of another State to a PE in that other State for the sole purpose of availing themselves of the domestic regime of that State. However, the Commentary immediately notes that there may be valid reasons for a holding being owned and managed by a PE rather than by the head office.

Given these divergent opinions, the Commentary advises States, when concluding a tax treaty, *“to make clear the interpretation they give to the first sentence of paragraph 3”*, for instance in a protocol[572]. At the same time, States could also solve the third issue referred to above,

[571] Comm. OECD on Art. 24, paras. 48-54.

[572] E.g. Point XV(2) of the Protocol to the 1970 Belgium/Dutch treaty: *“When a company which is a resident of one of the Contracting States has in the other State a permanent establishment with which a participation in the capital of a company which is a resident of the other State is effectively connected, the dividends pertaining to this participation are exempt in the other State from the taxes referred to in Article 2 to the extent that they would be exempt according to the law of that other State if the participation was held by a similar company which is a resident of that State”*. Similarly: point 8 of the Final Protocol to the 1970 Belgium/Luxembourg treaty.

that a PE holding shares would be treated more favourably than a resident company holding shares (because the PE can repatriate the dividends on its holding to the head office without attracting withholding taxes, whereas a resident company re-distributing the dividends would attract withholding taxes). This could be avoided by adapting the provisions of Art. 10(2) and (4), so as to enable a withholding tax to be levied in the PE State on dividends paid by resident companies to a PE of a resident company of the other State in the same way as if they were received directly, i.e. by the head office of the latter company (at a rate of 5 or 15%, depending on the size of the shareholding)[573].

Despite the Commentary's reluctance to take a definite position on this issue, the arguments against the domestic regime applying to PEs are quite weak[574]. First, there is the idea that, given the purpose of the domestic regime, the head office State is better placed to bear the cost. As mentioned repeatedly, Art. 24 does not offer the possibility of justifying discriminatory treatment. Taking account of the purpose of the measure, in casu the avoidance of double taxation[575], and then considering which State is more interested in this purpose, constitutes a justification argument. Arguments of this kind have no place under Art. 24. The second argument (that the loss of tax revenue resulting from the application of the domestic regime can be recovered by a subsequent taxation) can be dismissed on similar grounds. From the perspective of the State whose tax system is under scrutiny, loss of tax revenue is a justification ground, which has no place under Art. 24. From the perspective of the taxpayer, this argument could be seen as an aspect of the disadvantage test: the advantage gained by the object of comparison (a resident company) at one stage (i.e. the application of the beneficial domestic regime) is counterbalanced by a disadvantage at a subsequent stage (i.e. the subsequent taxation upon the distribution of dividends). Conversely, the subject of comparison (the PE) does not suffer the disadvantage of subsequent taxation, with the result that denying the advantage at issue would not lead to less favourable treatment. However, as

---

573 See, however, the discussion in the next section, on the application of withholding taxes on payments received by the PE. Examples of treaties where such provisions are included are Art. 10(6) of the 1975 treaty between Brazil and Germany: *"Where a resident of the Federal Republic of Germany has a permanent establishment in Brazil, this permanent establishment may be subject to a tax withheld at source in accordance with Brazilian law. However, such a tax cannot exceed 15 percent of the gross amount of the profits of that permanent establishment determined after the payment of corporate tax related to such profits"* (point 6 of the protocol provides: *"It is understood that the provisions of paragraph 6 of Article 10 are not in conflict with the provisions of [the PE non-discrimination provision]"*.) and Art. 25(2)(b) of the 1989 treaty between France and Italy, in which the following sub-paragraph is added to the PE non-discrimination provision: *"Where a permanent establishment situated in a State receives dividends, interest or royalties arising in the other State and pertaining to property or rights effectively connected with its activities, such income may be taxed in the State in which it arises in accordance with the respective provisions of paragraph 2(b) of Article 10, paragraph 2 of Article 11 and paragraph 2 of Article 12. The State in which the permanent establishment is situated shall eliminate double taxation in accordance with the conditions provided in paragraph 1(a) or paragraph 2 of Article 24, disregarding the last clause. This provision shall apply wherever the enterprise of which the permanent establishment is a part has its place of management"*.

574 See also K. VAN RAAD, *o.c.*, 147-148; J. AVERY JONES, "The non-discrimination Article in tax treaties: Part 2", *British Tax Review* 1991, 431-432; B. GARRIDO, "Interaction between the interpretation of the non-discrimination provisions in tax treaties and in the EC Treaty: an apparent rather than real conflict", *EC Tax Review* 2009, 168-169.

575 See also Part III, 2.E.I.A.b.6, on the *Lenz*/*Manninen*-comparability, where the domestic measure's purpose of avoiding double taxation was taken into account in the comparability-test. Transposed to the present case, the situations would be comparable, as the susceptibilty to double taxation is identical for both subject (the non-resident's PE) and object of comparison (a resident carrying on the same activities). Compare with the German Bundesfinanzhof case of 2005 discussed in 2.D.II.B.a.5, where this issue was briefly addressed by the Court (albeit not in a very convincing manner).

disadvantages under Art. 24 should be considered in isolation, without interference from counterbalancing advantages, this line of reasoning should be dismissed as well[576].

The third argument for denying the benefits of the domestic regime to PEs is that, when the domestic regime is made conditional upon redistribution of the dividends, an extension of the regime to PEs would mean that they are treated more favourably than resident companies[577]. This argument, which is closely related to the second argument, once again has little to do with discrimination. What it adds to the second argument, is the idea that reverse discrimination would arise if the domestic regime were extended to PEs, given the absence of subsequent taxation upon distribution of profits. First, as mentioned earlier, the text of Art. 24(3) does not preclude reverse discrimination. Nothing in that provision prevents a State from granting a non-resident taxpayer's PE more favourable treatment than its own residents. Secondly, the possibility that reverse discrimination may arise because of the extension of a domestic measure to non-residents cannot remove the discrimination that would arise if the domestic measure were denied. Art. 24(3) prohibits States from treating PEs less favourably than residents and that prohibition includes denying certain benefits to PEs which are available to residents. While it is possible that the result of the application of Art. 24(3) to such measures – i.e. that the benefit should be extended to PEs – is that, because of the interplay of other mechanisms, PEs are better off than residents, this does not remove the discrimination that arises when the benefit is denied to PEs. If States feel that the reverse discrimination that results from their obligations under Art. 24(3) is undesirable, they should adapt either the treaty or their domestic law to ensure that Art. 24(3) is respected, while at the same time making sure that PEs are not better off than residents (i.e. equal treatment rather than mere non-discrimination). The solution proposed in the Commentary (see supra) may serve as an example: allowing the PE State to levy withholding taxes at the rate provided for in Art. 10 of the treaty would be in line with Art. 24(3), while at the same time ensuring that dividends distributed to PEs are not treated more favourably than dividends distributed to residents.

The fourth argument given in the Commentary concerns the risk that companies of one State might transfer their holdings in companies of another State to a PE in that other State for the sole purpose of availing themselves of the domestic regime of that State. While this may be a legitimate concern, tackling such forms of treaty abuse is not a matter of Art. 24. States wishing to counter treaty-shopping structures have a wide variety of tools at their disposal both in domestic law and in tax treaty law (e.g. limitation on benefits clauses)[578]. The application and interpretation of Art. 24 should not be affected by these considerations.

In conclusion, Art. 24(3) requires the PE State to extend the benefits of such domestic regimes to the PE, unless the treaty limits this right or unless the application of Art. 24(3) is

---

[576] For an example in case law where this argument was rejected, see the 1993 decision of the Brussels Court of Appeal, discussed in 2.D.II.B.a.2. See also the ECJ's case law on this issue, Part III, 2.E.I.B.

[577] See also supra, the discussion of the U.S. branch profits tax, the purpose of which was to 'equate' the taxation of a non-resident's branch with the taxation of a resident company by levying an additional tax on the branch (and which should be considered as contrary to Art. 24(3)).

[578] See also Comm. OECD on Art. 10, para. 32: *"It has been suggested that Art. 10(4) could give rise to abuses through the transfer of shares to permanent establishments set up solely for that purpose in countries that offer preferential treatment to dividend income. Apart from the fact that such abusive transactions might trigger the application of domestic anti-abuse rules, it must be recognised that a particular location can only constitute a permanent establishment if a business is carried on therein and, also, that the requirement that a shareholding be 'effectively connected' to such a location requires that the shareholding be genuinely connected to that business."*

overridden by an anti-avoidance mechanism[579]. The same is true for domestic regimes in respect of foreign dividends[580].

d. Withholding tax on dividends, interest and royalties received by a PE

Articles 10, 11 and 12 do not apply where the beneficial owner of the dividends, interest or royalties, being a resident of a Contracting State, carries on business through a PE situated in the other Contracting State in which the income arises and the holding, debt-claim or the right or property in respect of which the income is paid is effectively connected with that PE. In such case, the provisions of Article 7 apply[581]. As a result, the source State of the income (where the PE is also situated) is not bound by the limitation of withholding tax laid down in those provisions, which means that the source State is free to apply its withholding tax at the full rate[582].

According to the Commentary, this approach does not create any problems with regard to Art. 24(3) if a withholding tax is levied on all such income, whether it is paid to residents or to non-residents (subject to the limitations of Articles 10, 11 and 12) and if PEs – like residents – are allowed to set the withholding tax off against the tax on profits due by virtue of Article 7. In that case, PEs are not treated less favourably than residents carrying on the same activities.

The situation is different, however, when the withholding tax is applied exclusively to income paid to non-residents. In that case, the application of the withholding tax is difficult to reconcile with the principle set out in Art. 24(3) that, for the purpose of taxing the income which is derived from their activity or which is normally connected with that activity (as is recognised to be the case with dividends, interest and royalties referred to in Arts. 10(4), 11(4) and 12(3)), PEs must be treated as resident enterprises and therefore in respect of such income be subjected solely to tax on profits. According to the Commentary, it is up to the Contracting States to settle this issue in bilateral negotiations[583]. That conclusion is not very satisfying. If

---

[579] For an example of case law: see supra, 2.D.II.B.a.5, on the judgment of the Conseil d'Etat of 18 November 1985, concerning the French participation exemption regime. The Court decided that the regime should be extended to the PE of the Italian taxpayer on the basis of the PE non-discrimination clause. Other examples are the Belgian cases discussed in 2.D.II.B.a.2 and 2.D.II.B.a.3.

[580] See also J. AVERY JONES, "The non-discrimination Article in tax treaties: Part 2", *British Tax Review* 1991, 432.

[581] Articles 10(4), 11(4) and 12(3) OECD MC, respectively. Comm. OECD on Art. 24, para. 62 refers in this regard to Comm. OECD on Art. 24, para. 53, which proposes to adapt Art. 10(2) and (4), so as to enable a withholding tax to be levied in the PE State on dividends paid by resident companies to a PE of a resident company of the other State in the same way as if they were received directly by the head office of the PE (see supra). See also Art. 7(7) OECD MC and Comm. OECD on Art. 7, para. 62: *"It has seemed desirable, however, to lay down a rule of interpretation in order to clarify the field of application of this Article in relation to the other Articles dealing with a specific category of income. In conformity with the practice generally adhered to in existing bilateral conventions, paragraph 7 gives first preference to the special Articles on dividends, interest etc. It follows from the rule that this Article will be applicable to business profits which do not belong to categories of income covered by the special Articles, and, in addition, to dividends, interest etc. which under paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12 and paragraph 2 of Article 21, fall within this Article."*

[582] Comm. OECD on Art. 24, para. 63. See also Comm. OECD on Art. 10, para. 31, Comm. OECD on Art. 11, para. 24 and Comm. OECD on Art. 12, para. 20, where it is pointed out that these provisions are not based on the 'force of attraction' principle, according to which income arising in a Contracting State is, by legal presumption, related to a PE which a resident of the other Contracting State has in the source State. The provisions only relieve the source State from the limitations on withholding tax if the income is effectively connected with the PE.

[583] Comm. OECD on Art. 24, paras. 64-66.

the practice described here is contrary to Art. 24(3) – which the Commentary suggests by pointing out that it is *"difficult to reconcile"* with the principle set out in that provision – then there is no need for any clarification on a bilateral basis. The Commentary should be less ambiguous in this respect, and make it clear that this less favourable treatment of PEs is contrary to Art. 24(3)[584].

In other words, the Commentary's approach is that Contracting States wishing to include the clause proposed in Comm. OECD on Art. 24, para. 53 (see supra, on the treatment of dividends received by PEs) should take account of the requirements of Art. 24(3) as regards withholding taxes. Art. 24(3) precludes the levying of the withholding tax solely on dividends paid to PEs of non-residents. In order to remedy this, States can either extend the application of the withholding tax to dividends paid to residents, or include an express provision in their treaty to the effect that Art. 24(3) does not preclude such withholding tax to be levied solely on dividends paid to PEs.

> See, for instance, Article 24(3)(b) of the 1987 Belgian/U.K. treaty: *"Nothing in this Article shall be construed as preventing Belgium from imposing the movable property prepayment on dividends derived from a holding which is effectively connected with a permanent establishment […] maintained in Belgium by a company which is a resident of the United Kingdom […]."* See also the discussion in this regard in 2.B.II.B.a.3, where it was noted that this provision is, strictly speaking, redundant insofar as Belgium levies withholding tax both on dividends paid to residents and to the PEs of non-residents. There is no discrimination of PEs in that case.

e. Credit for foreign tax and the extension to PEs of the benefit of tax treaties concluded with third States

Where domestic law grants resident taxpayers relief for foreign tax borne on income from foreign sources, Art. 24(3) requires the PE State to extend such relief to a PE in receipt of foreign income[585]. The situation is more difficult, however, where a resident of State R has a PE in State PE which receives income from State Y and in State PE, credit for tax levied in State Y is only allowed by virtue of the PE/Y tax treaty. As the PE is not a resident of State PE, it is not entitled to the benefits of the PE/Y treaty. The question then arises whether Art. 24(3) of the R/PE treaty requires State PE to extend these benefits to PEs of State R residents situated in State PE[586]. In other words, to what extent is State PE required to credit the tax that the taxpayer cannot recover under the R/Y treaty?

It is generally thought that Art. 24(3) does not require the PE State to extend these benefits to the PE. This has traditionally been explained by referring to the relative effect of tax treaties: because the treaty only has effect between the Contracting States, the benefits of the PE/Y

[584] See also F. VANISTENDAEL, "Taxation and non-discrimination, a reconsideration of withholding taxes in the OECD", *World Tax Journal* 2010, 190.

[585] Comm. OECD on Art. 24, para. 67. Even though the Commentary only refers to credits, the same is true for exemptions. See also J. AVERY JONES, "The non-discrimination Article in tax treaties: Part 2", *British Tax Review* 1991, 433.

[586] The 2007 Public Discussion Draft suggests that the answer is in the negative: *"As regards paragraphs [67] to [72], which deal with extension to permanent establishments of **domestic rules** granting relief of juridical double taxation in the case of dividends, interest and royalties received from another State, the Working Group concluded that it should be confirmed that paragraph 3 of Article 24 requires States to extend relief of double taxation to permanent establishments **but also to clarify that this does not mean that the permanent establishment is entitled to treaty benefits as if it were a resident**."* (OECD Public Discussion Draft, 3 May 2007, Application and interpretation of Article 24 (non-discrimination), para. 58; emphasis added).

treaty should be confined to residents of those States[587]. On the other hand, it has been suggested that the relative effect of tax treaties only means that the **source State Y** is not required to grant the benefits of the PE/Y treaty to residents of a third State (i.e. State R)[588]. That principle does not imply that the PE State can deny the benefits of the PE/Y treaty to residents of a third State with a PE in that State. Consequently, where the PE State has agreed in treaty PE/Y to provide double taxation relief to its residents, that State is required under Art. 24(3) of the R/PE treaty to extend the relief granted to its own residents to State R residents with a PE in State PE, including relief granted under the PE/Y treaty. The relative effect of the PE/Y treaty does not preclude this: that principle only means that State Y is not required to extend the benefits it granted under that treaty to residents of a third State[589].

However, it should be pointed out that the absence of obligations for State Y is just one aspect of the relative effect of tax treaties. As mentioned earlier, the underlying reason for the principle of relative effect is the inherent reciprocal nature of tax treaties, and that reciprocal nature also has implications for State PE's position (see infra).

The Commentary notes that *"there is agreement that double taxation arises in these situations and that some method of relief should be found."* The Commentary therefore proposes to add a sentence to Art. 24(3) of the relevant treaty, in order to allow the PE State to credit the tax liability in the source State of the income to an amount that does not exceed the amount that residents of the PE State can claim on the basis of that State's treaty with the source State[590]. If the withholding tax under the treaty R/Y is lower than that under the treaty

[587] See e.g. the 1977 Comm. OECD on Art. 24, para. 54, where it is stated that Art. 24(3) cannot be invoked in this respect because of *"the well-known principle of the relative effect of treaties, which means that they have effect only as between the Contracting States."*

[588] See also Art. 34 of the Vienna Convention: *"A treaty does not create either obligations or rights for a third State without its consent."*

[589] K. VAN RAAD, "Triangular cases", *European Taxation* 1993, 299.

[590] Comm. OECD on Art. 24, para. 70 might not seem entirely conclusive as to what the correct interpretation of Art. 24(3) is. First, it is pointed out that *"the majority of Member countries are able to grant credit in these cases on the basis of their domestic law or under paragraph 3."* It seems that this is a general statement intended to clarify what happens in practice when the situated illustrated in para. 69 arises (i.e. if the PE in State PE of a State R resident receives dividends or interest from a third State Y, should State PE grant relief for the State Y tax?). According to para. 70, most States grant relief *"on the basis of their domestic law or under paragraph 3."* That is to say, some States grant relief both to residents and to non-residents having a PE in their territory (*"on the basis of their domestic law"*). On the other hand, where the relief under domestic law is restricted to residents, then Art. 24(3) requires the PE State to extend this to residents of the other Contracting States with a PE in their territory (*"under [Art. 24(3)]"*). Only where domestic law does not provide for any relief, but where treaty PE/Y does, there is a problem. In that case, Art. 24(3) does not offer a solution. In order to resolve this issue, the only solution is to include a clause in the PE/Y treaty requiring the PE State to grant a credit (which is what the Commentary proposes). Therefore, the Commentary supports the position that, in the absence of any specific clause to that effect, Art. 24(3) does not require the PE State to extend the benefits of the treaty PE/Y to State R residents with a PE in their territory. On the other hand, it could be said that the Commentary does not give preference to either interpretation. Particularly, the statement that *"the majority of Member countries are able to grant credit in these cases […] under paragraph 3"* could also mean that a number of States agree that Art. 24(3) as it is worded in the OECD MC does indeed require the PE State to extend the benefits of the treaty PE/Y to the PE of a State R resident. The proposed clause clarifying this position is only intended for States that do not agree with this interpretation. This would mean that the Commentary does not offer support for either interpretation, but only describes the divergent practice of the different countries. However, the latter interpretation is not entirely convincing. It is clear that para. 70 concerns the general issue described in para. 69 (see the first two sentences of para. 70: *"double taxation arises in **these** situations […]. The majority of Member countries are able to grant credit in **these** cases […]"* (emphasis added)). In other words, para. 70 concerns both the situation where State PE's domestic law contains a relief mechanism and the situation where the only relief mechanism can be found in treaty PE/Y. In the former case, if the relief mechanism is restricted to residents, then Art. 24(3) requires State PE to extend it to the PE of a State R resident. In the latter case, Art. 24(3) as it is

PE/Y, then only the lower tax collected in the source State is credited in the PE State[591]. In the example given above, suppose that the withholding tax in the R/Y treaty is 10%, while it is 15% in the PE/Y treaty. Applying the R/Y treaty, State Y withholds 10% upon payment of the income. If Art. 24(3) of the R/PE treaty contains a clause to extend the credit under the PE/Y treaty to PEs of State R, then State PE is only required to grant a credit for the 10% of tax withheld by State Y under the R/Y treaty, even though the PE/Y treaty provides for a withholding rate of 15%.

The same is true if the withholding rate under the R/Y treaty is higher than that under the PE/Y treaty. Suppose the rate is 15% under the R/Y treaty, while it is 10% under the PE/Y treaty: the amount of credit granted to the PE should not exceed the amount that a resident of State PE can claim under the PE/Y treaty. Consequently, State PE grants a credit of 10% to the PE, even though State Y has applied a withholding tax of 15% under the R/Y treaty.

> What if the credit were granted in domestic law of State PE instead of the treaty PE/Y? Suppose that there is no treaty between State PE and State Y. Under the treaty R/Y, State Y's domestic withholding rate of 25% is reduced to 10%. State PE grants its residents a credit for foreign tax withheld on income from foreign sources. Art. 24(3) of the treaty R/PE requires State PE to extend the domestic credit to the PE. Obviously, the PE in State PE will only be entitled to a credit for the 10% of tax actually levied in State Y, as the non-discrimination clauses only prohibits less favourable treatment of PEs (which, in the present case, implies the obligation for State PE to grant the PE the possibility to credit the tax withheld abroad, like the residents of State PE).
>
> The situation is more complex, however, where there is no treaty between State R and State Y[592], while the treaty PE/Y provides that State Y's domestic withholding rate of 25% is reduced to 10%. Once again, State PE's domestic law grants residents a credit for tax withheld abroad. Upon payment, State Y withholds tax at the domestic rate of 25%. Art. 24(3) requires State PE to apply its domestic credit to the State Y income received by the PE. As domestic law grants a credit for the tax withheld at source, this credit should not be limited to 10% but should cover the full 25% withheld in State Y (even though State PE residents in receipt of State Y income would only be entitled to a credit of 10%)[593].

---

worded in the OECD MC does not offer a solution. The only solution would be to supplement Art. 24(3) of the treaty R/PE with an express provision dealing with this issue. See also the 1992 OECD Triangular Cases Report (§ 48), which resulted in the insertion of the paragraphs of the Commentary discussed here: *"For it to be clearly spelt out that permanent establishments in State P enjoy the same advantages as State [PE]'s own enterprises, it would have to be agreed that express reference to this treatment be made in the treaty between State R and State [PE]. Possibly, for instance, it could be stipulated in the Article on non-discrimination that permanent establishments of enterprises of State R would be entitled, in the same way as residents of State [PE], to a tax credit in respect of income from third countries."*

[591] The following wording is proposed in the Commentary: *"When a permanent establishment in a Contracting State of an enterprise of the other Contracting State receives dividends or interest from a third State and the holding or debt-claim in respect of which the dividends or interest are paid is effectively connected with that permanent establishment, the first-mentioned State shall grant a tax credit in respect of the tax paid in the third State on the dividends or interest, as the case may be, by applying the rate of tax provided in the convention with respect to taxes on income and capital between the State of which the enterprise is a resident and the third State. However, the amount of the credit shall not exceed the amount that an enterprise that is a resident of the first-mentioned State can claim under that State's convention on income and capital with the third State."* If the treaty between the PE State and the taxpayer's State of residence also provides for other categories of income that may be taxed in the State in which they arise and for which credit should be given (e.g. royalties, in some conventions), the proposed provision should be amended to also cover these (see Comm. OECD on Art. 24, para. 70).

[592] Or where the withholding rate under the treaty R/Y is higher than that under the treaty PE/Y.

[593] See also K. VAN RAAD, "Issues in the application of tax treaty non-discrimination clauses", *B.I.F.D.* 1988, 348.

Once again, the Commentary then addresses the possibility of abuse. If State R exempts the profits of the PE situated in the other Contracting State, there is a risk that the taxpayer will transfer assets such as shares to a PE in a State offering a favourable tax treatment, which may lead to the resulting income remaining untaxed. To prevent this, the Commentary proposes to include a provision in the treaty R/Y, stating that the taxpayer can only claim the benefits of that treaty if the income obtained by the PE is taxed normally in State PE. Finally, the Commentary observes that other triangular cases may arise, e.g. where the taxpayer's State of residence (State R) is also the source State of the income attributable to the PE (State Y). According to the Commentary, States can settle these matters in bilateral negotiations[594].

An interesting example of another possible triangular situation is discussed by LOUKOTA and WOLFF[595]. A German partnership, which is transparent under German tax law and treated as a PE under Art. 5 OECD MC, carries out a construction project in the U.K. that lasts 13 months. The partners of the German partnership are all Austrian residents. Suppose that the treaty between Austria and the U.K. follows the 12 month threshold of Art. 5(3) OECD MC, while the treaty between Germany and the U.K. provides for an 18 month threshold for construction projects. The question arises whether Germany can tax the income from the construction project.

According to LOUKOTA, the non-discrimination clause of the treaty between Germany and Austria precludes Germany from taxing the German partnership on the profits from the construction project. At first sight, Art. 24 of the Austrian/German treaty would leave Germany free to tax the profits, because if a German resident carries out a construction project in the U.K. for a period of 13 months, the profits from that project are taxable exclusively in Germany and the U.K. has to exempt them. However, the treaty between German/U.K. treaty is irrelevant here, because the German partnership is a resident of neither Germany, nor the U.K. Only the Austrian/U.K. treaty applies, and that treaty allows the U.K. to tax the profits. If Germany were to tax the profits as well, there would be double taxation contrary to the non-discrimination clause of the Austrian/German treaty. As German residents are entitled to a credit for tax levied abroad under domestic law, Art. 24(3) of the Austrian/German treaty requires Germany to extend the credit to the German partnership and allow it to credit the U.K. tax withheld at source against the German tax due.

In contrast, WOLFF argues that Germany is free to tax the profits from the construction project in the U.K. Germany does not apply its treaty with the U.K., because the taxpayer is not a resident of either State. As a result, there is no treaty protection in Germany. However, Germany would grant a credit for taxes levied in the U.K. but the legal basis for this credit is German domestic law, not the treaty between Austria and Germany. The fact that, under the treaty between Austria and the U.K., the profits in question are exclusively taxable in the U.K. is irrelevant for Germany. Consequently, there is no treaty provision that prevents Germany from taxing the partnership's profits arising in the U.K.

Arguably, the latter position is to be preferred. As Germany is not a party to the Austrian/U.K. treaty, there is nothing to prevent Germany from allocating the U.K. income to the German partnership and including it in the taxable base in Germany. If any relief is given for the U.K. tax, this should be derived from domestic law. In case domestic law

[594] Comm. OECD on Art. 24, paras. 71-72, referring to Comm. OECD on Art. 21, para. 5. As will be argued below, this issue is not triangular in nature but concerns a conflict between different provisions of the tax treaty between the PE State and the taxpayer's State of residence (which, at the same time, is the source State of the income; see 2.D.III.C.e.1, on the 2006 judgment of the Brussels Court of First Instance).

[595] Discussed in M. LANG, H. LOUKOUTA, R. WALDBURGER, M. WATERS and U. WOLFF, "Triangular situation: partnership with sub-permanent establishment in third countries", *SWI* 2004, 14-16.

grants the same credit to the partnership as it does to German residents, there is no problem of discrimination. On the other hand, if the partnership is not entitled to relief under German domestic law, then Art. 24(3) of the Austrian/German treaty requires Germany to extend the domestic relief to the partnership[596].

III.C. Case law

a. Assessment of tax

1. Brussels Court of Appeal 30 June 1994[597]

A German transport company had a PE in Belgium. Belgian domestic tax law provided that, where a taxpayer did not keep proper accounts, tax could be assessed on the basis of a comparison with similar taxpayers (taxation by comparison) or on a lump-sum basis (Art. 342(1) ITC). Furthermore, a fixed minimum applied when this provision was applied to non-resident taxpayers (Art. 342(2) ITC and 182 RD/ITC[598]). The taxable basis for non-resident taxpayers in the transport sector was € 2.5 per € 25 turnover, with a minimum of € 15,000 per employee. As the taxpayer in the case at issue had not kept any accounts for his Belgian PE, the Belgian tax administration taxed the PE on this basis.

---

[596] See also the case discussed in M. LANG, J. LÜDICKE, P. RIEDWEG, "Steueranrechnung und Betriebsstättendiskriminierungsverbot der DBA bei Dreieckssachverhalten", *Internationales Steuerrecht* 2006, 73-78. A German resident taxpayer has a PE in Switzerland, through which it earns 10% of its total income of EUR 10 million. The PE holds shares in an Austrian company and receives dividends of EUR 100,000 in respect of these shares (being 10% of its profits). In the treaty between Switzerland and Austria, the withholding tax in Switzerland is reduced to 15% and Austria is required to grant a credit for the tax so withheld. However, this treaty cannot be applied as the taxpayer is not a resident of either State. Consequently, Austria can apply its full withholding rate and Switzerland can fully include the dividends in the profits allocable to the PE, resulting in double taxation. There is no domestic provision in Swiss law allowing for a credit for foreign taxes. Switzerland is only required to grant a credit where this is provided for in a tax treaty. According to the authors, however, Switzerland has to give a credit under the PE non-discrimination clause of the German/Swiss treaty. The wording of the clause does not imply that its application should be limited to situations where the discrimination results from domestic law, excluding situations where the discrimination results from tax treaty law. Moreover, it cannot be reconciled with the object and purpose of the non-discrimination clause if a Contracting State would be able to side-step its application merely by 'packaging' a discrimination in a tax treaty with a third State, rather than in domestic law (*"Der Wortlaut des Betriebsstättendiskriminierungsverbotes lässt jedenfalls nicht erkennen, dass die Vorschrift nur Schutz vor nach originär innerstaatlichem Recht begründeten Diskriminierungen, nicht aber vor Diskriminierungen, die auf das Abkommensrecht zurückzuführen sind, gebieten würde. Ebenso wenig wäre es mit Ziel und Zweck des Diskriminierungsverbotes vereinbar, wenn einer der Vertragsstaaten den Anwendungsbereich des Diskriminierungsverbotes alleine dadurch unterlaufen könnte, dass er eine Diskriminierung nicht in seinem originär innerstaatlichen Recht vorsieht, sondern in ein bilaterales DBA mit einem Drittstaat 'verpackt'. All dies spricht dafür, die Art. 24 Abs. 3 OECD-MA nachgebildeten bilateralen DBA-Normen auch auf Drittstaatsabkommen anzuwenden."*). In my opinion, even though the double taxation arising in this case is unfortunate, the proposed interpretation of Art. 24(3) goes well beyond the limits imposed on it by the principle that tax treaties have relative effect. As the PE is not a resident of Switzerland, it is not entitled to the credit under the Austrian/Swiss treaty. Moreover, because of the relative effect of the Austrian/Swiss treaty (and, underlying that, its inherent reciprocal nature), that credit is not part of the treatment which Switzerland is required to apply in a non-discriminatory manner to its residents and to PEs of non-residents under Art. 24(3). Neither the wording of the clause, nor its object and purpose alter the fact that the non-discrimination clause is inherently limited in its application to triangular situations, because of the relative effect of tax treaties.

[597] *A.F.T.* 1995, 102-103.

[598] At the relevant time, these provisions were numbered Art. 248(2) ITC and 146 RD/ITC.

According to the taxpayer, this method of taxation amounted to discrimination contrary to Art. 24(4) of the 1967 Belgian/German tax treaty[599]. The Court of Appeal, however, dismissed this claim. The Court first noted that the PE non-discrimination clause of the treaty did not preclude the PE of a German taxpayer being taxed **differently** for practical purposes than a Belgian enterprise, only that it would be taxed **less favourably** than a Belgian enterprise. According to the Court, there was no less favourable treatment in the present case, because a Belgian enterprise in similar circumstances would also be subject to taxation on a lump-sum basis[600].

The Court's conclusion is not entirely convincing. It is correct that a Belgian resident who does not keep proper accounts may also be subject to taxation on a lump-sum basis (Art. 342(1) ITC). However, the calculation of that lump-sum basis differs significantly from the calculation applied to non-resident taxpayers. For resident taxpayer, the lump-sum basis is calculated on the basis of objective criteria, taking account of the taxpayer's purchasing volume, the turnover of taxpayers in the same sector, the region where the taxpayer is active, etc. In contrast, the lump-sum basis for non-resident taxpayers is calculated without taking any account of the taxpayer's characteristics that might affect his profit margin. As a result, it is possible that PE of a non-resident taxpayer is treated less favourably than a resident taxpayer carrying on the same activities[601].

2. Commerzbank AG v IRC[602]

The taxpayer was a German bank with a PE in the U.K., through which it made loans to a number of U.S. companies. The U.K. tax authorities claimed that the taxpayer was liable for corporation tax in the U.K. on the interest it received on the loans. The taxpayer succesfully argued that the U.K. corporation tax was contrary to Art. XV of the U.K./U.S. treaty, because it was not a resident of the U.K.[603] Pending the litigation, the taxpayer had paid the tax demanded and now claimed repayment of the tax unduly paid and a 'repayment supplement' (i.e. interest on the overdue repayment of tax[604]). As only resident taxpayers were eligible for the repayment supplement, the U.K. tax authorities dismissed this claim. The taxpayer argued that this refusal was contrary to the PE non-discrimination clause of the German/U.K. treaty[605].

The High Court dismissed the taxpayer's argument, on the ground that it was **interest on taxation**, not taxation itself, which was being less favourably levied: "*the repayment*

[599] Identical to Art. 24(3) of the 1963 OECD Draft Convention.
[600] In 2003, the Court reached the same conclusion under the PE non-discrimination provision of the 1970 treaty with the Netherlands: Brussels Court of Appeal 12 November 2003, *T.F.R.* 2004, No. 265, 684-686. See also Brussels 15 September 1995, discussed in M. WAUMAN, "Vaste inrichting. Voldoende onderling verband tussen werven", *Fisc. Int.* 1995, No. 143, 6-7.
[601] See also J. DILLEN and H. VANDEBERGH, "De belastbare forfaitaire minimumwinsten voor buitenlandse ondernemingen: een discriminatoire bepaling in de Belgische fiscale wetgeving?", *R.W.* 1981, No. 27, 1753-1776.
[602] High Court (Queen's Bench Division) 12 April 1991, *R. v Inland Revenue Commissioners Ex p. Commerzbank AG*, [1991] S.T.C. 271. The decision has been touched upon earlier, in the context of Art. 24(1); see supra, 2.B.VI.B.
[603] High Court (Chancery Division) 9 February 1990, *CIR v. Commerzbank AG; CIR v. Banco do Brasil SA*, [1990] S.T.C. 285.
[604] See section 825 of the Income and Corporation Taxes Act 1988 (hereafter: "the 1988 Act").
[605] Apart from this tax treaty discrimination issue, the question also arose whether the U.K. provisions were compatible with the fundamental freedoms. That question was ultimately decided by the ECJ (see Part III, 2.E.I.A.a.1.b).

supplement, although connected with the levy of taxation, does not affect the amount of that levy." As pointed out earlier, this interpretation is correct on the text of Art. 24(3), which does not preclude discrimination of PEs as regards formalities connected with the discrimination, as long as this does not result in less favourable taxation. Here, the repayment supplement was a formality connected with the taxation. Even though this formality was applied less favourably to PEs, there was no discrimination since the taxation itself was not less favourable[606]. Arguably, the same conclusion should be upheld where it is the taxpayer, and not the tax administration, who is required to pay interest on overdue tax. Suppose that PEs of non-residents are required to pay interest on overdue tax, while residents are not. This is closely connected with the taxation, but it does not affect the taxation itself. As the taxation itself is not less favourable, Art. 24(3) does not preclude such a differentiation. While this result might seem undesirable, it is in line with the text of Art. 24(3).

It should be stressed that the Court's conclusion may also have been affected by U.K. domestic law, particularly section 788(3) of 1988 Act[607]. Pursuant to that provision, tax treaties concluded by the U.K. only had effect in domestic law *"in so far as they provide for"* relief from tax, for charging non-residents on income from sources in the U.K., for determining the income to be attributed to non-residents or their resident associates, or for conferring on non-residents a tax credit on dividends. As the repayment supplement could not be brought within this language, the PE non-discrimination provision had no effect in this regard. In other words, even if the taxpayer had won his argument on the basis of the treaty, he would have ultimately lost because U.K. domestic law did not give full effect to the treaty[608].

> Interestingly, the Court also attaches some importance to the taxpayer's overall attitude throughout the proceedings. In particular, the Court notes that the taxpayer *"can hardly complain of unfair discrimination by reference to its non-resident status in the matter of the repayment supplement when its right to the repayment itself is based solely upon that very status."* In other words, the taxpayer first succesfully recovered the U.K. corporation tax on the basis that he was not a resident of the U.K.[609]. In the case at issue, the taxpayer complained that the repayment supplement was only available to residents. According to the Court, the taxpayer was *"trying to have the best of both fiscal worlds, that of the non-resident under the provisions of the [U.K./U.S. treaty], and that of the resident under section 825 [of the 1988 Act]."*

---

[606] As pointed out in 2.B.VI.B, the Court expressly recognized – in the context of Art. 24(1) – that the repayment supplement was a 'formality connected with the taxation. However, Art. 24(1) was to no avail, as the national measures differentiated on the basis of residence rather than nationality.

[607] *"Subject to the provisions of this Part, the arrangements shall, notwithstanding anything in any enactment, have effect in relation to income tax and corporation tax in so far as they provide*

> *(a) for relief from income tax, or from corporation tax in respect of income or chargeable gains; or*
> *(b) for charging the income arising from sources, or chargeable gains accruing on the disposal of assets, in the United Kingdom to persons not resident in the United Kingdom; or*
> *(c) for determining the income or chargeable gains to be attributed*
>
> > *(i) to persons not resident in the United Kingdom and their agencies, branches or establishments in the United Kingdom; or*
> > *(ii) to persons resident in the United Kingdom who have special relationships with persons not so resident; or*
>
> *(d) for conferring on persons not resident in the United Kingdom the right to a tax credit under section 231 in respect of qualifying distributions made to them by companies which are so resident."*

[608] See also J. AVERY JONES, "Non-discrimination: Commerzbank – round two", *British Tax Review* 1991, 407.

[609] I.e. in the case of 9 February 1990, discussed earlier, where the taxpayer held that Art. XV of the U.K./U.S. treaty precluded the U.K. from taxing the interest, because he was not a U.K. resident.

The tax authorities had argued that, if one took account of the taxpayer's overall position, he was not discriminated against but treated more favourably than a resident taxpayer. He came to be subjected to the disadvantage at issue which was only imposed on non-residents (the inability to recover interest on overpaid tax) because he had made use of an advantage only available to non-residents, namely the ability to recover the overpaid tax in the first place. Had the taxpayer been a resident, he would have had to pay the tax, and there would have been no issues of recovery. Consequently, the comparison made by the taxpayer, between a resident and a non-resident claiming interest on overpaid tax recovered was too narrow. Instead, the comparison should be widened to embrace the whole transaction, i.e. the circumstances of the claim for overpaid tax as well as the linked claim for interest on that tax. A resident could never be in a position to reclaim that tax in those circumstances, so no meaningful comparison with a resident could be made. And if no comparison can be made, then neither an advantage nor a disadvantage could be identified.

Because the Court had already dismissed the taxpayer's argument under Art. 24(3) on other grounds[610], it did not address this point in detail in the context of the tax treaty. However, it expressly addressed this point in formulating its question referred to the ECJ. In particular, the Court wondered whether, when considering a composite transaction, it should focus only on the actual incident in which the alleged disadvantage is to be found (i.e. the claim for interest in the present case), or whether it should look at the whole transaction, i.e. the overpayment of tax, the circumstances of the recovery of that tax, and the claim for interest on it. According to the Court, *"a comparison with a resident is possible in the first instance, and if such a comparison is legitimate, the disadvantage to the non-resident is plain. But once the court's perspective is widened to include the circumstances of the recovery of the tax, no such comparison between treatment of a resident and a non-resident is possible, and so the disadvantage or unequal treatment vanishes, as one is then looking at a transaction which is only open to non-residents, which brings them some benefits, but not all that they would wish for."* The Court thus concludes that the ECJ is *"best placed to decide whether the orderly development of the Community will be best served by the domestic court taking a narrow view in its identification of disadvantage, or looking at a broader perspective to see whether the disadvantage is in fact real."*

As will be discussed in Part III, 2.E.I.B.c.2, the ECJ ultimately decided that *"a national provision such as the one in question entails unequal treatment. Where a non-resident company is deprived of the right to repayment supplement on overpaid tax to which resident companies are always entitled, it is placed at a disadvantage by comparison with the latter. The fact that the exemption from tax which gave rise to the refund was available only to non-resident companies cannot justify a rule of a general nature withholding the benefit. That rule is therefore discriminatory"*[611]. In other words, the ECJ refuses to take the wide approach proposed by the U.K. tax authorities.

The same approach should be taken with regard to Art. 24(3). The discrimination at issue should be considered in isolation, without interference from counterbalancing advantages. There is no reason why the perspective of the disadvantage-test should be extended by considering other advantages that may othweigh the disadvantage incurred[612].

[610] See supra: the taxpayer's claim concerned interest on taxation, not taxation itself.
[611] C-330/91, *Commerzbank*, § 18-19.
[612] See also supra, on the isolationist approach to be taken under the comparability-test of Art. 24(3).

3. Automated Securities Clearance[613]

The taxpayer was a U.S. company with a PE in India. Indian domestic tax law at the material time provided for a tax incentive to promote the export of computer software. Indian residents were entitled to a deduction of eighty percent of the profits earned in respect of the export of computer software or its transmission from India to a place outside India by any means[614]. The taxpayer argued that the restriction of the benefit to residents violated the PE non-discrimination provision of the Indian/U.S. treaty[615]. The first instance court decided in favour of the tax authorities, on the basis that the allowance was restricted to residents on account of their 'civil status' of being a resident of India. As the PE non-discrimination provision did not apply to benefits granted on account of a taxpayer's civil status, the Court therefore dismissed the taxpayer's claim. The taxpayer objected against this decision to the Income Tax Appellate Tribunal (ITAT).

The taxpayer referred to the OECD Commentary on Art. 24(3), where it is pointed out that tax incentives for the development of economically backward regions or the promotion of new activities necessary for the expansion of the economy should be extended to PEs, since *"such measures are in furtherance of objectives directly related to the economic activity proper of the State concerned"*[616]. As the taxpayer was allowed to engage in the business activity in question, and fulfilled all the necessary conditions and requirements to do so[617], the PE non-discrimination provision required the deduction to be extended to the PE.

As to the first instance court's decision that the benefit in question was granted on account of the taxpayer's civil status, the ITAT correctly points out that this expression is only relevant for individuals (see infra, 2.D.III.D)[618]. However, the ITAT ultimately dismisses the taxpayer's claim, thereby relying to a significant extent on the Technical Explanation of the U.S. Model Convention.

According to the ITAT, the U.S. Technical Explanation is an authoritative statement of the U.S.' treaty policy. Therefore, *"this authoritative statement, which is binding on one of the treaty partners, has a very strong persuasive value on the ground of reciprocity as well. In the case of tax treaties in which U.S. is a partner, Technical Explanation to the U.S. Model Convention is indeed the best guide for contemporaneous thinking on the expressions finding place in the tax treaty. […] When an expression appearing in the U.S. Model Convention is being used in a tax treaty, and unless there is anything to the contrary is placed on record, this expression shall have the same meaning, intent and context as assigned to the expression in the Technical Explanation. […] When there is a conflict [between the OECD Commentary and the U.S. Technical Explanation], howsoever basic or seemingly trivial, the OECD Model Convention Commentary has to give way to the Technical Explanation to the U.S. Model Convention"*[619].

---

[613] Indian Income Tax Appellate Tribunal (Pune 'B' Bench) 10 September 2008, *Automated Securities Clearance Inc. v Income Tax Officer*, No. ITA 1758/Pn/2004.

[614] Sec. 80HHE Income Tax Act 1961.

[615] Art. 26(2) of the 1989 treaty between India and the U.S. which, for purposes of the case at hand, was identical to Art. 24(4) OECD MC 1977.

[616] Comm. OECD on Art. 24, para. 43-44. According to the Tribunal, however, what the Commentary states here *"is nothing more than its wish list and it is not free from doubt or controversy as to whether such tax incentives can be extended only to residents"* (ITAT, *Automated Securities Clearance Inc. v Income Tax Officer*, para. 60).

[617] See Comm. OECD on Art. 24, para. 45-46.

[618] ITAT, *Automated Securities Clearance Inc. v Income Tax Officer*, paras. 68-69.

[619] ITAT, *Automated Securities Clearance Inc. v Income Tax Officer*, paras. 30-31.

As the interpretation given by the Technical Explanation to the non-discrimination provision is different from the interpretation in the OECD Commentary, the ITAT therefore decides that the latter should give way to the former in the present case.

Referring to Van Raad[620], the ITAT first holds that, in order to establish discrimination, *"a taxpayer has to demonstrate [not only] that he has been subjected to different treatment vis-à-vis other taxpayers, but also that the ground for this differentiation in treatment is unreasonable, arbitrary or irrelevant"*[621]. According to the ITAT, this 'principle of reasonableness of the differential treatment' is also evident from the U.S. Technical Explanation, for instance where it is stated that *"it would not be a violation of the nondiscrimination protection of paragraph 2 to require the foreign enterprise* ***to provide information in a reasonable manner*** *that may be different from the information requirements imposed on a resident enterprise, because information may not be as readily available to the Internal Revenue Service from a foreign as from a domestic enterprise"* (emphasis added).

Another example given by the ITAT concerns the obligation under U.S. domestic tax law for partnerships with U.S. income to withhold tax on amounts allocable to a foreign partner. Even though no such obligation applies with respect to amounts allocable to a U.S. resident partner, the Technical Explanation that this does not give rise to discrimination: *"In distinguishing between U.S. and non-U.S. partners, the requirement to withhold on the non-U.S. but not the U.S. partner's share is not discriminatory taxation, but, like other withholding on nonresident aliens,* ***is merely a reasonable method for the collection of tax*** *from persons who are not continually present in the United States, and as to whom it otherwise may be difficult for the United States to enforce its tax jurisdiction"* (emphasis added).

Given the persuasive value of the Technical Explanation, the ITAT thus concludes that *"when the treaty partner State takes the stand that a differential treatment, which meets the test of reasonableness, cannot be construed as discrimination under [the PE non-discrimination clause], and with a view to ensure reciprocity in treatment, the same stand should ideally be followed by the other treaty partner State"*[622].

Furthermore, Art. 26(5) of the Indian/U.S. treaty states that *"nothing in this article [i.e. the non-discrimination Article] shall be construed as preventing either Contracting State from imposing the taxes described in Article 14 (Permanent establishment tax)"*[623]. The additional U.S. tax on an Indian taxpayer's PE in the U.S. obviously leads to less favourable treatment

[620] K. VAN RAAD, *o.c.*, 8: *"At present, the term [discrimination] is restricted to instances where the discriminated person is treated with less, rather than more, favour. In addition, the term nowadays implies that, in view of the nature of the treatment concerned, the grounds of differential treatment are unreasonable, arbitrary or irrelevant. Whether a distinction is unreasonable, arbitrary or irrelevant is a matter of judgment."*
[621] ITAT, *Automated Securities Clearance Inc. v Income Tax Officer*, para. 35.
[622] ITAT, *Automated Securities Clearance Inc. v Income Tax Officer*, paras. 36-37.
[623] Art. 14(a) of the treaty provides: *"A company which is a resident of India may be subject in the United States to a tax in addition to the tax allowable under the other provisions of this Convention. Such tax, however, may be imposed only on: the portion of the business profits of the company subject to tax in the United States which represents the dividend equivalent amount; and […] the excess, if any, of interest deductible in the United States in computing the profits of the company that are subject to tax in the United States and either attributable to a permanent establishment in the United States or subject to tax in the United States under Article 6 […], Article 12 […] as fees for included services, or Article 13 […] of this Convention over the interest paid by or from the permanent establishment or trade or business in the United States."*

of that PE as compared to U.S. enterprises, and yet it is not considered to constitute discrimination under the treaty[624]. Unlike the OECD Model, the differentiation between residents and non-residents is *"institutionalized in the Indian/U.S. tax treaty."* This supports the ITAT's contention that in order to establish discrimination, demonstrating differential treatment, by itself, cannot suffice. In order to establish discrimination, it must be demonstrated that *"the basis of differentiation lacks any coherent relationship with the object sought to be achieved by the legal provision which is alleged to be discriminatory"*. The ITAT finds further support for this position in Indian constitutional concept of non-discrimination, which is traditionally interpreted as allowing distinctions that are reasonable, objective and proportionate[625].

Therefore, it is necessary to take note of the differences between the PE and a resident and to consider whether the differentiation introduced by the domestic measure is reasonable in the light of these differences. Mere differential treatment of the PE as compared to a resident, by itself, cannot constitute discrimination. As long as such differentiation can be justified on the grounds of dissimilarities in their situation, there is no discrimination. In the present case, the question thus arose whether the denial of the investment deduction in India was reasonably justified in light of the differences between the PE of a U.S. company and an Indian resident.

The relevant Indian measure distinguished on the basis of residence: residents were entitled to a deduction for the export of software, while non-residents were not. According to the ITAT, it was reasonable to grant an export-related tax incentive only to residents. One of the main motivations for granting such an incentive is *"to augment foreign exchange reserves of the country. It can be reasonably assumed that to the extent the export profits are earned, such profits are likely to be retained in the country of fiscal domicile. Therefore, a view is indeed possible that an economy gains more when a resident taxpayer makes profits on export, rather than a situation in which exports are made by a non-resident taxpayer."* Therefore, the difference in treatment in the present case had a reasonable relationship to the object sought to be achieved by the legislation in question and it was neither arbitrary nor irrelevant. As a result, the ITAT held that the denial of the incentive to the taxpayer's PE did not constitute discrimination[626].

Put briefly, the ITAT concludes that it is justified to restrict export-related tax incentives to resident taxpayers because they would be more likely to retain the profits in India, their State of residence. Such a line of reasoning would justify almost any discrimination against the PE of a non-resident. Moreover, Art. 24 does not allow for justification grounds. The ITAT tries to side-step this by referring to the inherent 'reasonableness' in the non-discrimination provision and the necessity to relate the existing differences between the subject and object of comparison to the reasonable nature of the distinction. However, there is nothing in Art. 24 that makes the existence of discrimination subject to a condition of reasonableness.

Most likely, the ITAT's peculiar line of reasoning has been affected to a significant extent by the importance it accorded to the U.S. Technical Explanation of the U.S. Model Convention. To a certain extent, this is a relevant instrument when interpreting a treaty concluded with the U.S., as the U.S.' unilateral view of the interpretation of U.S. tax treaties. However, it should not be given as much weight as the OECD Commentaries in situations where the treaty

[624] See supra, 2.D.III.B.b.3.
[625] ITAT, *Automated Securities Clearance Inc. v Income Tax Officer*, paras. 38, 40 and 64.
[626] ITAT, *Automated Securities Clearance Inc. v Income Tax Officer*, paras. 46-48.

provision at issue is based on the OECD Model[627]. There is some merit in taking account of the other contracting State's unilateral view on the matter, but that view cannot 'set aside' the importance of the OECD Commentaries[628].

An interesting argument brought forward by the ITAT in this regard is that India should follow the U.S.' unilateral interpretation of the treaty *"with a view to ensure reciprocity in treatment"*[629]. Consequently, when the U.S. takes the position that a certain difference in treatment does not constitute discrimination because it is reasonable, India should take the same position in order to ensure reciprocity. If not, the non-discrimination provision would be applied differently to Indian residents having a PE in the U.S. as compared to U.S. residents having a PE in India. As pointed out earlier, the precise meaning of 'reciprocity' is difficult to grasp, but it seems unlikely that it entails the obligation for a contracting State to consistently follow the other contracting State's interpretation of the treaty. There is certainly a need for a degree of uniformity in the interpretation and application of the treaty, but ideally, that uniformity should not merely be achieved at the bilateral level. Rather, it would seem preferable to take the OECD approach as the starting point for the interpretation, particularly where the treaty provision in question is identical to the relevant provision of the OECD Model. Assuming that reciprocity requires a contracting State to adhere to the interpretation given to the treaty by its treaty partner would effectively mean that the interpretation of tax treaties in a given State is fragmentized depending on which treaty is applied.

Suppose, for instance, that the treaty between India and the U.K. is identical to the Indian/U.S. treaty. Suppose further that the U.K., in its unilateral interpretation of tax treaties, would take a different approach from the U.S. and would consider a certain differentiation to constitute discrimination, while the U.S. does not. In that case, India would apply the two identical non-discrimination provisions differently to PEs in India depending on whether the taxpayer is resident of the U.K. or the U.S. Obviously, these taxpayers have no claim to most favoured nation-treatment under the bilateral tax treaties, but this approach is nevertheless questionable from the point of view of legal certainty which tax treaties seek to ascertain.

Finally, the argument that the U.S. Technical Explanation provide for a general 'reasonableness exception' to the prohibition of discrimination in not very convincing. The examples given there are merely two instances where the U.S. take the position that a difference in treatment is not discriminatory. To infer from these examples that the non-discrimination provision as such is subject to a general reasonableness-test is quite far-fetched.

> The ITAT expressly overturned its decision in *Automated Securities Clearance* in the later *Shri Rajeev Sureshbhai Gajwani*-case[630]. The exact same issue arose in that case, also under the Indian/U.S. treaty. However, the ITAT held in the latter case that the refusal to grant the tax incentive fell foul of the PE non-discrimination clause because it gave rise to less favourable taxation of the PE of a U.S. resident. The ITAT concludes its judgment in *Shri Rajeev Sureshbhai Gajwani* by noting that *Automated Securities Clearance* is *"not in conformity with"* the PE non-discrimination clause: *"It appears that the Bench [in*

[627] See also B. ARNOLD, "Tax treaty news", *B.I.F.D.* 2009, 269.
[628] Of course, the OECD Model and the Commentary are not binding, especially on courts of non-member States of the OECD, such as India. However, they have a strong persuasive value (more so than the unilateral view of the other contracting State), particularly when the wording of the treaty provision at issue is identical to the wording of the relevant provision in the OECD Model.
[629] ITAT, *Automated Securities Clearance Inc. v Income Tax Officer*, para. 37.
[630] ITAT (Special Bench) 4 March 2011, *Shri Rajeev Sureshbhai Gajwani*, ITA No. 1807 and 1978/ Ahd/ 2006.

Autmated Securities Clearance] unnecessarily considered the commentary and the technical explanation. The plain meaning of the provisions was not considered. […] Therefore, we are of the considered view that the Division Bench erred in coming to the conclusion that the assessee was not entitled to deduction under section 80 HHE."

4. Saipem

The Court's decision

The facts of this case were already set out in 2.B.V.B.f. Apart from the nationality non-discrimination clause, the taxpayer also invoked the PE non-discrimination clause of the Canadian/U.K. treaty, which is identical to Art. 24(3) OECD MC. The taxpayer argued that the PE non-discrimination clause requires loss carry-back and carry-forward rules avaible to domestic enterprises to be extended to PEs of residents of the other contracting State. Therefore, the taxpayer's Canadian PE should be able to deduct the losses previously incurred by its wound-up subsidiary's Canadian PE.

The Tax Court of Canada dismissed the taxpayer's claim. The Court first refers to the Commentary dealing with the assessment of tax in the context of Art. 24(3) (see supra) and then observes that that Commentary is in line with paragraphs 1 to 3 of Article 7 of the Canadian/U.K., which followed Art. 7 of the 1963 OECD Draft Convention[631]. In that respect, the Court notes that Art. 7 does not specifically deal with the deduction of losses, but *"it would seem logical to infer and conclude that the only loss deductions possible in determining the profits of the PE are those with respect to losses that would be attributable to the PE if it were dealing wholly independently with the enterprise of which it is a PE. This is what I believe the parties intended to agree to in Article 7"*[632].

The Court then held that the taxpayer in the case at hand wanted to deduct losses from its PE income that did not result from that PE's own activities in Canada. Since such a deduction was not allowed under Article 7 of the Canadian/U.K. treaty, the tax authorities' refusal to allow the deduction did not violate the PE non-discrimination clause of that treaty. According to the Court, that non-discrimination clause only applied to the taxation of the PE's **own activities**. Therefore, it does not extend to *"provisions that take into account the relationship between an enterprise and other enterprises and that allow the transfer of losses"*[633].

Finally, the Court notes that the taxpayer was not being treated less favourably than a Canadian enterprise carrying on the same activities and wanting to deduct losses of non-resident subsidiaries that have a PE in Canada. Since such a Canadian enterprise was not entitled to the deduction either, there was no discrimination[634].

[631] The only deviation from the 1963 Draft is the following addition in Art. 7(3) of the Canadian/U.K. treaty (addition in bold): *"In the determination of the profits of a permanent establishment situated in a Contracting State, there shall be allowed as deductions expenses of the enterprise **(other than expenses which would not be deductible under the law of that State if the permanent establishment were a separate enterprise)** which are incurred for the purposes of the permanent establishment including executive and general administrative expenses, whether incurred in the State in which the permanent establishment is situated or elsewhere."*

[632] Tax Court of Canada 14 January 2011, *Saipem UK Limited*, para. 67.

[633] Tax Court of Canada 14 January 2011, *Saipem UK Limited*, para. 69.

[634] As with respect to its decision under the nationality non-discrimination clause (see 2.B.V.B.f), the Court thus takes a two-step approach to its analysis under the PE non-discrimination clause. First, it dismisses the claim of discrimination brought forward by the taxpayer, by pointing out that the taxpayer's analysis is incorrect. The taxpayer compared its situation (a U.K. resident company with a PE in Canada is unable to deduct the losses of its U.K. resident subsidiary's PE in Canada after that subsidiary is wound up) with that of a Canadian resident with a Canadian resident subsidiary (who is able to deduct the subsidiary's losses after winding-up). The Court

Commentary

The Court's position that Art. 24(3) does not extend to provisions that take into account the relationship between an enterprise and other enterprises and that allow the transfer of losses is reminiscent of the statement included in the Comm. OECD since 2008 that Art. 24(3) *"only applies to the taxation of the permanent establishment's own activities"* and that it therefore *"does not extend to rules that take account of the relationship between an enterprise and other enterprises (e.g. rules that allow consolidation, transfer of losses or tax-free transfers of property between companies under common ownership) since the latter rules do not focus on the taxation of an enterprise's own business activities similar to those of the permanent establishment but, instead, on the taxation of a resident enterprise as part of a group of associated enterprises"*[635].

In my opinion, that interpretation is too restrictive. Provisions that *"take into account the relationship between an enterprise and other enterprises"* should not be excluded *a priori*. Instead, it should be ascertained whether the PE of a non-resident suffers a disadvantage that a resident enterprise carrying on the same activities does not suffer (see supra, 2.D.III.B.a)[636]. If it does, there is discrimination (assuming that the situations are comparable). In the present case, it is clear that the taxpayer's PE was treated less favourably than a resident enterprise. The non-discrimination rule would therefore require the benefit to be extended to the PE. However, it should then be verified whether other treaty provisions oppose the extension of that benefit to the PE. In the case at hand, the Court takes a somewhat similar approach by reading the limitation on Canada's taxing powers under Art. 7 directly into the non-discrimination provision. That is to say, the Court interprets the PE non-discrimination provision against the backdrop of the limitation of taxing powers under Art. 7 and holds that, logically, the non-discrimination clause can only relate to taxation of the PE's own activities with the result that losses suffered by another PE cannot be deducted[637].

As the Commentary confirms, the non-discrimination clause should be read in the context of the other provisions of the convention, so that measures that are mandated or expressly authorized by those provisions cannot be considered to violate the non-discrimination clause[638]. So the Court's argument that Art. 24(3) should be read in the context of Art. 7, with the result that the protection from discrimination only concerns the taxation of the PE's own activities, is reasonable. However, it would be incorrect to infer therefrom that provisions that

---

decides that Art. 24(3) cannot be interpreted that way because it is only concerned with losses relating to the PE's own activities. Secondly, the Court argues that the appropriate comparison is with a Canadian enterprise that wants to deduct losses suffered by its non-resident subsidiary's Canadian PE. Since the proper object of comparison is not entitled to the deduction either, there is no less favourable treatment and, therefore, no discrimination.

[635] Comm. OECD on Art. 24, para. 41.

[636] See also L. HINNEKENS and P. HINNEKENS, "General report", in IFA, *Cahiers de droit fiscal international. Non-discrimination at the crossroads of international taxation,* Vol. 93a, Amersfoort, Sdu Fiscale & Financiële Uitgevers, 2008, 30, who note that *"this seems to be a very restrictive interpretation since, in our view, the participation of a PE in a consolidation tax regime relates to the profits (or losses) of the PE itself. Based on Article 24(3) a PE should be entitled to the same tax incentives and relief mechanisms as a resident company exercising the same activities, including group relief."*

[637] It is unclear to what extent the Court was influenced in this context by the deviating wording of Art. 7(3) of the Canadian/U.K. treaty. As mentioned above, that provision differed from the OECD MC in that it expressly excludes the deductibility of *"expenses which would not be deductible under the law of that State if the permanent establishment were a separate enterprise"*.

[638] Comm. OECD on Art. 24, para. 4.

take into account the relationship between an enterprise and other enterprises are by definition excluded from the scope of the provision. As noted above, it is possible that such a rule comes within the scope of Art. 24(3). But after ascertaining that it does (i.e. that the rule concerns the taxation of the PE itself), it is necessary to verify whether other treaty provisions oppose the extension of the benefit at issue to the PE.

> As will be discussed in 2.F.I.B, there is a similar issue under Art. 24(5). In that context, the Commentary also stresses that the ownership non-discrimination clause only protects the resident company, the capital of which is owned by residents of the other contracting State. As a result, it does not apply to domestic rules that grant tax benefits to a group of companies as a whole, since that would require comparing the combined treatment of the resident company and its non-resident subsidiary with that of a resident company and its resident subsidiary.
>
> From that premiss, the Commentary derives that rules that take account of the relationship between the subject of comparison and other companies (e.g. consolidation rules, rules on the transfer losses, etc.) are not covered by Art. 24(5). As will be argued in 2.F.I.B, the position in the Commentary is too narrow as it cannot be excluded that such a rule results in a benefit for the subject of comparison considered in isolation. For instance, a rule that allows losses to be transferred should not be automatically disregarded because it applies in a group context. The relevant question is whether the subject of comparison is denied a tax benefit which is granted to the object of comparison. Of course, the issue is confounded because other treaty provisions limit the extent to which a contracting State can take account of, e.g. the profits of a non-resident parent company in the context of consolidation rules. But that should not affect the analysis under the non-discrimination rule.

b. Structure and rate of tax

Obviously, the application of higher tax rates to PEs of non-resident taxpayers is incompatible with Art. 24(3). Yet, the Indian Authority for Advance Rulings (the AAR) came to a different conclusion in a case involving the French/Indian treaty[639]. The taxpayer was a French bank with a PE in India. According to the taxpayer, the higher rate imposed on its PE was contrary to the PE non-discrimination clause of the treaty.

The AAR dismissed this claim on the basis of three arguments. First, the distinction between domestic and foreign companies as regards the rate of tax has long been in existence in Indian tax law. The tax treaty with France was drafted with the full knowledge of this long-standing distinction. Since the non-discrimination provision did not expressly preclude this distinction, it could not be said to constitute discrimination contrary to the tax treaty[640].

Secondly, the term 'taxation' in the non-discrimination clause did not refer to the rate of tax. According to the AAR, "*it is not possible to hold that the non-discrimination clause was drafted for the purpose of ensuring that the rate of tax on a French company and an Indian company will be the same. Article 26 does not speak of rate of tax at all.*" According to the AAR, the purpose of the PE non-discrimination provision is to ensure that no 'special', additional tax is imposed on the PE of a non-resident. But that provision does not preclude the imposition of the same tax at a higher rate[641].

[639] Indian Authority for Advance Rulings, 4 December 1998, *In Re: Application No. P-16*, *ITR* 1999, 236, 103 AAR. See also J. SHAH, "Indian courts limit treaty benefits", *International Tax Review* 1999, Vol. 10, Issue 5, 36.
[640] See paras. 12-17 of the ruling.
[641] See paras. 36-45 of the ruling.

Finally, the taxpayer referred to the treaty between India and the U.K., in which the PE non-discrimination provision expressly provided that it did not prevent a Contracting State from subjecting the PE of a resident of the other Contracting State to a higher rate of tax than than applied to the profits of a similar enterprise of the first-mentioned State. According to the taxpayer, the absence of such a provision in the treaty with France implied that a higher tax rate on PEs was discriminatory. However, the AAR disagreed, and held: *"We are of the view that the non-discriminatory* [sic] *clause both in the French agreement and the U.K. agreement are to be construed similarly. Merely because a rule of construction which is specifically provided in the U.K. agreement is missing from the French agreement does not lead to the conclusion that the same rule of construction will not apply to the French agreement. In our view, the U.K. agreement has made explicit what was implicit in the French agreement"* [642].

The AAR's arguments are not very convincing. First, the fact that that the treaty does not expressly prohibit a 'long-standing' discrimination does not mean that that discrimination is excluded from the scope of application of the non-discrimination provision. Secondly, it does not seem correct to argue that a higher rate of tax is not 'taxation' within the meaning of Art. 24(3) OECD MC. Clearly, subjecting a non-resident's PE to a higher rate of tax constitutes "taxation that is less favourably levied". Finally, the statement that the exception contained in the treaty with the U.K. merely confirms what is implicit in the treaty with France is not supported by any convincing legal arguments. I do not see why an express exception to the non-discrimination rule that is included in some treaties should be considered implicitly present in the non-discrimination rule of other treaties[643].

c. Dividends received in respect of holdings owned by a PE

1. UBS AG

This case was already touched upon earlier, in 2.D.II.B.b.3. The disadvantage at issue was that the taxpayer's PE was not entitled to the payment of a tax credit in a situation where a resident company would have been entitled to such payment.

In the U.K. between 1973 and 1999, an imputation system of corporation tax applied to the taxation of dividends. Under that system, a U.K. resident company paid corporation tax on all its profits, whether or not distributed. No income tax was deducted from dividend distributions, but **a company making distributions** to its shareholders made a payment of advance corporation tax (ACT) in respect of such distributions. The ACT was 'imputed' to the distribution and so 'franked' it. The sum of the amount of the distribution and the ACT was called a 'franked payment'.

---

[642] See paras. 51-57 of the ruling.

[643] That being said, the decision was arguably correct as a matter of Indian law. Since India is a dualist State, a tax treaty is in principle only binding insofar as it is incorporated into domestic law. Tax treaties concluded by India are given legal force by virtue of Article 90 of the Income Tax Act 1961. That provision expressly states: *"For the removal of doubts, it is hereby declared that the charge of tax in respect of a foreign company at a rate higher than the rate at which a domestic company is chargeable, shall not be regarded as less favourable charge or levy of tax in respect of such foreign company."* To that extent, the tax treaty therefore has no overriding effect (treaty underride). The same approach was taken by the Income Tax Appellate Tribunal (Mumbai Bench) in *Mashreqbank psc v Deputy Director of Income Tax*, 13 April 2007, 9 *ITLR* 1062, para. 28, which also concerned a higher rate of tax imposed on a non-residents' PE. Since the treaty did not have binding effect as regards the distinction between the tax rates, that distinction was held not to constitute discrimination.

ACT paid in respect of distributions made in an accounting period could be set off against the corporation tax on the distributing company's profits for that period, the so-called 'mainstream corporation tax'. Unrelieved ACT, known as 'surplus ACT', could be carried back or forward to be set off against mainstream corporation tax from other accounting periods[644].

Neither a U.K. resident company, nor a PE in the U.K. were subject to corporation tax on dividends received. However, a U.K. resident **recipient** of a distribution in respect of which ACT was payable was entitled to a tax credit corresponding to the ACT[645]. If the recipient of the dividend was a company, the amount of the dividend plus the amount of the tax credit constituted 'franked investment income'[646]. A U.K.-resident company was liable to pay ACT only in respect of the excess of its franked payments over its franked investment income. This meant that ACT was paid only once in respect of dividends passed up through U.K.-resident members of groups of companies[647]. Accordingly, the main use of the tax credit was to frank qualifying distributions by the recipient company and so to be set against that company's liability to pay ACT. Any surplus FII, i.e. the amount of FII left after franking the distributions, could be rolled forward to subsequent accounting periods.

However, for certain purposes, e.g. the setting off of trading losses, the surplus FII could be made to release its tax credit for immediate use. The surplus FII was then treated as if it were profits against which the trading losses could be set off. Consequently, a company with surplus FII (i.e. franked investment income which exceeded franked payments[648]) could, if it had losses, set those losses against the surplus FII[649] and obtain a payment in cash of the amount of the tax credit comprised in that surplus FII (s 242(1) ICTA 1988; see example 1). The same applied where the company had losses carried forward from previous accounting

[644] S 239 ICTA 1988.
[645] S 231(1) ICTA 1988.
[646] S 238(1) ICTA 1988.
[647] The U.K. ACT regime has given rise to a number of disputes. The primary issue was that group income elections were only available if both parent and subsidiary were residents of the U.K. Consequently, where the parent was a non-resident, the subsidiary never had the option to pay dividends without attracting ACT liability. In *Metallgesellschaft*, the ECJ held that this differentiated treatment violated the freedom of establishment where the parent company had its seat in another Member State (see Joined cases C-397/98 and C-410/98, *Metallgesellschaft*, 8 March 2001, discussed in Part III, 2.E.I.A.b.5.a). This resulted in various claimants initiating proceedings against the U.K. tax authorities. Because the issues were related, a group litigation order (GLO) was made. In 2001, the ACT GLO was divided into four classes (see A. BIRLA, "United Kingdom", in IFA, *Cahiers de droit fiscal international. Non-discrimination at the crossroads of international taxation*, Vol. 93a, Amersfoort, Sdu Fiscale & Financiële Uitgevers, 2008, 623):

- Class 1 (concerning an EU parent): the issue decided by the ECJ in favour of the taxpayer in *Metallgesellschaft*;
- Class 2 (concerning an EU parent but where a tax treaty conferred on that parent an entitlement to a repayable U.K. tax credit): House of Lords 8 February 2006, *Pirelli Cable Holding NV*, 8 *ITLR* 872 (which will not be discussed since no issues of discrimination were addressed);
- Class 3 (concerning a non-EU parent): *Boake Allen* (discussed in 2.F.II.D.d);
- Class 4 (ECJ 12 December 2006, C-374/04, *Test Claimants in Class IV of the ACT Group Litigation*, discussed in Part III, 2.E.1.A.b.6); the issue there was similar to the *UBS*-case but the ECJ decision only concerned the non-resident's entitlement to the tax credit, while *UBS* also concerns the additional issue of surplus franked investment income.

[648] That is to say, where a U.K. resident company receives dividends giving rise to a tax credit (franked investment income) and also pays out dividends giving rise to ACT liability (franked payment) and the income exceeds the payment, i.e. where the FII (dividends received plus tax credit received) exceeds the franked payment (dividends paid plus ACT paid).
[649] In other words, for the purpose of setting off losses, the surplus FII was treated as if it were a like amount of profits chargeable to corporation tax.

periods: the losses could be set against the surplus FII and the company was entitled to a payment in cash of the tax credit comprised in the surplus FII (s 243(1) ICTA 1988)[650].

> Example: application of s 242(1) ICTA 1988[651]
>
> A U.K. resident company has a trading loss of 6,000. It has received qualifying distributions of 7,500 from another resident company on which there is a tax credit of 2,500, making franked investment income of 10,000. The company pays a dividend of 3,750 and would have to pay ACT of 1,250[652] but uses 5,000 of its FII to frank the payment to avoid having to pay ACT. The result is that the company has surplus FII of 5,000. The loss of 6,000 can be set off against the surplus FII and the credit of 1,250 (corresponding to the 5,000 surplus FII) will be repaid to the company. This will leave a loss of only 1,000 to be carried forward to the next year.
>
> This way, the tax credit comprised in the FII is released and the FII is reduced. At first sight, this might seem disadvantageous for the company, in that both the surplus FII and the funding loss (which might have been given relief at the corporate tax rate of 35% later on) are reduced. However, as will be pointed out below, it is possible to subsequently reinstate the trading loss: s 242(5) ICTA 1988 allows an excess of franked payments over FII to be treated as a loss available for corporation tax relief to the extent that the excess is less than the amount of the loss used to generate the relief under s 242(1) or s 243(1) ICTA 1988.

If in a later accounting period franked payments exceed franked investment income, the claim is reversed. The company will then pay ACT on the excess of franked payments and it is treated as having incurred a loss of the amount previously claimed up to that excess (s 242(5) ICTA 1988). In other words, the excess of franked payments over FII is treated as a loss available for corporation tax relief to the extent that the excess is less than the amount of the loss used to generate the relief under s 242(1) ICTA 1988. To achieve this, the loss is treated as occurring in the accounting period immediately before that in which the excess arises.

Furthermore, where a company has claimed payment in cash in respect of a tax credit under s 242(1) or s 243(1) ICTA 1988, an amount equal to that payment is deducted from any ACT which could normally be set off against mainstream corporation tax under s 239 ICTA 1988 ('surplus ACT'). If that amount exceeds the surplus ACT, the excess is carried forward and similarly deducted from the surplus ACT in the following accounting periods (s 244(2) ICTA 1988)[653].

The issue in the *UBS*-case was that the taxpayer's PE could not receive payment of the amount of the tax credit under s 243(1) ICTA 1988 because only resident companies could have franked investment income: the definition of FII was limited to *"income of a company*

[650] This payment of 'an amount equal to the tax credit' is not expressed to be a payment or repayment of corporation tax, see Special Commissioners 7 June 2005, *UBS AG v Revenue and Customs Commissioners*, 7 *ITLR* 893, 913.

[651] The example is taken from J. TILEY (ed.), *Butterworths U.K. Tax Guide 1989-90. Eighth edition*, London, Butterworths, 1989, 708. The relevant rates have changed somewhat in the subsequent years, but the basic reasoning behind this example illustrates the functioning of the system.

[652] The rate of ACT is tied to the basic rate of income tax (BR) and can be expressed as BR/(100-BR) (s 14 ICTA 1988), i.e. 25/(100-25) = 25/75. Here, the ACT is calculated as 3,750 x 25/75 = 1,250.

[653] For an example of the application of this mechanism, see J. TILEY (ed.), *Butterworths U.K. Tax Guide 1989-90. Eighth edition*, London, Butterworths, 1989, 709.

resident in the U.K.”[654]. The taxpayer argued that this was contrary to the PE non-discrimination provision.

The Special Commissioners

Before the Special Commissioners, the tax authorities argued that the provisions of U.K. tax law described above had to be seen as a whole. Particularly, s 242(5) and s 244(2) ICTA 1988 (which ensured a reversal of the claim if in a subsequent accounting period franked payments exceeded FII) could not apply to the PE because the PE could never have an excess of franked payments over franked investment income, so none of the provisions could apply. The tax authorities argued that a resident company received a **conditional** payment in respect of the tax credit under s 243(1) ICTA 1988. In contrast, if the PE was accorded the payment of s 243(1) by virtue of the non-discrimination provision of the tax, it would be an **absolute** payment (because s 242(5) and s 244(2) ICTA 1988 could never apply to the PE). Therefore, the tax authorities contended that the comparison could not be made from that perspective.

The tax authorities also argued that s 243 ICTA 1988 was not part of the process of levying tax[655] but a mechanism whereby a company could secure the payment of a tax credit from the tax authorities[656].

The Special Commissioners dismissed these arguments, pointing out first that the non-applicability of s 242(5) and s 244(2) ICTA 1988 did not prevent the comparison. The problem at issue was that the PE was not entitled to the payment under s 243(1) ICTA 1988, which was a provision related only to losses and the receipt of FII. The fact that there were other related provisions (i.e. s 242(5) and s 244(2) ICTA 1988) that were inapplicable to the PE did not prevent the comparison being made in relation to s 243(1) ICTA 1988. In other words, the provision under scrutiny had to be considered in isolation, without interference from other provisions that applied to the object of comparison.

The Special Commissioners also dismissed the second argument of the tax authorities. They acknowledged that, in a certain sense s 243(1) ICTA 1988 is a mechanism for securing payment of the tax credit, but the circumstance in which this occurs is by way of a relief for losses. In this respect, the provision is not different in nature from carrying losses forwards or backwards, which must be applied to a PE according to the Comm. OECD[657].

The tax authorities then advanced a somewhat similar argument: by virtue of Art. 11 of the treaty, foreign interest received was excluded from the taxation of the PE. In that respect, the PE was treated more favourably than a hypothetical U.K. resident company[658]. Once again,

---

[654] S 238(1) ICTA 1988: *“franked investment income means income of a company resident in the United Kingdom which consists of a distribution in respect of which the company is entitled to a tax credit (and which accordingly represents income equal to the aggregate of the amount or value of the distribution and the amount of that credit)”*

[655] And therefore not targeted by Art. 24(3) OECD MC, which prohibited less favourable levying of tax on PEs.

[656] See also supra, on the question whether Art. 24(3) is concerned with “formalities connected with the taxation”.

[657] See Comm. OECD on Art. 24, para. 40, discussed earlier.

[658] This argument only pertained to income year 1993, as the treaty was amended in 1993. Until 1993, Art. 11(1) of the treaty provided: *“Interest derived and beneficially owned by a resident of a Contracting State shall be taxable only in that State.”* In 1993, this was replaced by: *“Interest arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State if that resident is the beneficial owner of the interest.”*

the Special Commissioners took the position that the discrimination must be assessed in isolation: *"Nowhere in the Commentary is there any suggestion that a global approach should be taken so as to take account of each and every tax provision in either the domestic tax law of the contracting state or the treaty."* Consequently, the effect of the scrutinized measure on the PE as compared to the object of comparison should be considered *"without regard to the effect on either of other provisions which are not under scrutiny. […] The contrary global view would either make a comparison impossible (because it is always possible to point to some differences between a permanent establishment and a U.K. resident company which arguably put them in different circumstances or suggest that tax is not levied 'less favourably' on the present establishment) or draw arbitrary lines to determine which provisions other than the provision under scrutiny could or could not be considered. Here the treaty expressly treats the permanent establishment more favourably in one respect but the non-discrimination article must in the context of the treaty as a whole ignore this and intend that the less-favourably-levied test should be applied to other aspects of taxation"*[659].

In other words, counterbalancing advantages in favour of the subject of comparison do not remove the discrimination. Here, the counterbalancing advantage could be found in the treaty, but the conclusion is the same as for counterbalancing advantages found in domestic law: the disadvantage should be considered in isolation, without interference from other provisions.

The Special Commissioners then address the actual question as to whether the PE was treated less favourably than a resident company: *"we consider that payment of the tax credit is part of the levying of taxation and that the taxation on the [PE] is less favourably levied."* The reason for this was that a U.K. resident company in the same circumstances could claim from the tax authorities a payment in respect of the tax credit, while the PE could not. Moreover, if, in a later accounting period, the U.K. resident company pays more dividends than it receives (i.e. if franked payments exceed FII), then it will automatically receive a greater benefit at the cost of the claim being reversed and being 'repaid' in the form of ACT that cannot be set against mainstream corporation tax[660]. According to the Special Commissioners, this difference between the PE and the object of comparison cannot be described as a comparison between a conditional and (if the PE succeeds in his claim on the basis of the non-discrimination provision) an absolute one. Rather, it is *"payment to the hypothetical U.K. resident of at least the sum in respect of the tax credit, and possibly more; and (if the appellant succeeds) a payment to the appellant equal to that sum, but never a greater sum. In the words of the Commentary 'it is the result alone which counts.' Nothing can obscure the difference that before the application of the non-discrimination article the U.K. resident can on making a claim receive cash from the Revenue in respect of the tax credit, while the appellant cannot. That, in our view, is clearly taxation less favourably levied on the appellant"*[661].

As a result, the Special Commissioners decided that the refusal of the payment amounted to discrimination of the PE as compared to resident companies. However, the taxpayer's claim ultimately failed because the treaty was not fully incorporated into U.K. law with respect to

[659] Special Commissioners 7 June 2005, *UBS*, 7 *ITLR* 893, 917-918.
[660] See supra, if in a subsequent accounting period franked payments exceed FII, the excess of franked payments over FII is treated as a loss available for corporation tax relief.
[661] Special Commissioners 7 June 2005, *UBS*, 7 *ITLR* 893, 918-919.

this payment[662]. The taxpayer therefore appealed against the Special Commissioner's decision to the High Court.

The High Court (Chancery Division)

Before the High Court, the tax authorities again disputed the taxpayer's position that taxation was less favourably levied on the PE within the meaning of the PE non-discrimination provision. More precisely, no taxation was 'levied' on the PE: there were merely claims to a tax credit, which were rejected. The tax authorities referred to a dictionary definition of the term, according to which 'to levy' means *"to raise (contributions or taxes) or impose (a rate, toll, fee, etc.) as a levy, or to impose a levy on a person"*.

Furthermore, the tax administration argued that no tax had been 'levied' on the PE in respect of the relevant accounting periods because the PE's brought forward losses exceeded taxable profits for those years. If there are no taxable profits, after offset of losses, capable of giving rise to a charge of tax, there is no tax being 'levied'. In order to support this contention, the tax authorities relied on the OECD Commentary on Art. 24(3), where no reference is made to anything similar to the tax credit under s 243 ICTA 1988.

The High Court dismisses these arguments, pointing out that the levying of tax is a broad concept. It encompasses, as the dictionary definition shows, the imposition of a tax. That does not mean that a taxpayer will actually be liable to pay an amount of tax after, for example, allowances and reliefs. The tax is 'imposed' or 'levied', but there may be nothing to be paid by a particular taxpayer. Consequently, the tax credit payable under s 243 ICTA 1988 is part of the levying of corporation tax, notwithstanding that that provision only applies in circumstances where the company's losses are such that there could never be any liability to make an actual payment of tax.

Finally, the Court holds that the OECD Comm. does not support the tax authorities' arguments: there is nothing in the Commentary which points with any certainty to exclude provisions such as s 243 ICTA 1988 from the scope of Art. 24(3). On the contrary, Comm. OECD on Art. 24, para. 35[663] is more consistent with the taxpayer's arguments and with the approach taken by the Special Commissioners[664].

As a result, the High Court decides that the inability for the PE to claim the payment of the credit was contrary to the PE non-discrimination clause. Since the High Court decided in favour of the taxpayer (also with respect to the incorporation into U.K. law)[665], the tax authorities appealled to the Court of Appeal.

Court of Appeal (Civil Division)

[662] Special Commissioners 7 June 2005, *UBS*, 7 *ITLR* 893, 919-926. See also the similar issues in e.g. *Commerzbank* (2.D.III.C.a.2) and *Boake Allen* (2.F.II.D.d).
[663] *"By the terms of the first sentence of paragraph 3, the taxation of a permanent establishment shall not be less favourably levied in the State concerned than the taxation levied on enterprises of that State carrying on the same activities. The purpose of this provision is to end all discrimination in the treatment of permanent establishments as compared with resident enterprises belonging to the same sector of activities, as regards taxes based on business activities, and especially taxes on business profits."*
[664] High Court (Chancery Division) 7 February 2006, *UBS*, 8 *ITLR* 595, 609-611.
[665] High Court (Chancery Division) 7 February 2006, *UBS*, 8 *ITLR* 595, 613-623.

The Court of Appeal unanimously decided that U.K. domestic law does not give the taxpayer a remedy in the present case. As a result, the claim was dismissed. However, the different members of the Court of Appeal reached different conclusions on the question whether the treaty non-discrimination provision was violated[666]: Moses LJ decided that the inability for the PE to claim the payment of the credit was contrary to the PE non-discrimination clause, while Arden LJ thought that it was not. Sedley LJ preferred to express no opinion, since this point was not necessary to the Court's decision.

The tax authorities had reiterated their position that taxation was not less favourably levied because, in the years at issue, the PE had no liability to tax. From that perspective, U.K. tax law imposed no greater burden on the PE than on any company resident in the U.K. Moses LJ disagreed with this approach, holding that the prohibition in Art. 24(3) is a prohibition against less favourable treatment in the imposition of tax on PEs. In this respect, he noted that there were three stages in the imposition of a tax: the declaration of liability, the assessment and the collection[667].

The basis of computation forms part of the first stage, the imposition of liability. Only when the basis of computation has been identified, can there be any liability. And the determination of the entitlement of a U.K. resident company to a tax credit is part of the process of computation of its liability. Consequently, the determination of this entitlement forms part of the first stage of the imposition of tax.

Moses LJ then notes that the Comm. OECD is not sufficiently clear to provide assistance to either party's arguments. In particular, the contrast in the language of Art. 24(1) and (5), which prohibit more burdensome 'taxation and connected requirements', and the language of Art. 24(3) *"defies sensible explanation"*. If, as the tax authorities argued, Art. 24(3) was intended to confine non-discrimination to 'what must be paid', *'there is no reason why the negotiators did not adopt the reference to more burdensome taxation, the expression they used elsewhere. The omission of any reference to treatment is unnecessary by virtue of the reference to taxation being **levied**"*[668].

In conclusion, Moses LJ decides that there is no reason for limiting the prohibition of discrimination under Art. 24(3) merely to the stage of collection. It makes no sense to do so, as collection depends upon the prior processes of computation, liability and return or assessment. Consequently, Art. 24(3) requires the tax on a PE to be computed and its liability to be determined as if it was a resident company. And the process of determining whether a company is entitled to a tax credit is part of the process by which liability is declared. Therefore, the inability for the PE to claim payment of the credit violated the PE non-discrimination provision of the treaty.

---

[666] Obviously, this disagreement on the interpretation of the treaty did not make a difference for the taxpayer, as the case was ultimately decided in favour of the tax authorities on the basis of domestic law (i.e. on the basis that domestic law does not give the taxpayer a remedy in the present case). For the purpose of the present study, however, the different views on the interpretation of the treaty non-discrimination provision are highly interesting.

[667] Court of Appeal (Civil Division) 21 February 2007, *UBS*, 9 *ITLR* 767, 774-775, referring to the following citation of Lord Dunedin in House of Lords 6 November 1925, *Whitney v Inland Revenue Commissioners* [1926] *A.C.* 37, 52: *"there are three stages in the imposition of a tax: there is the declaration of liability, that is the part of the statute which determines what presons in respect of what property are liable. Next, there is the assessment. Liability does not depend on assessment. That, ex hypothesi, has already been fixed. […] Lastly, come the methods of recovery, if the person taxed does not voluntarily pay."*

[668] Court of Appeal (Civil Division) 21 February 2007, *UBS*, 9 *ITLR* 767, 776.

Arden LJ disagreed with this interpretation. She first notes that the words 'the taxation' (as used in the PE non-discrimination provision) are not defined in the treaty[669]. In this respect, Arden LJ dismisses the suggestion of Moses LJ that the term 'taxation' comprises three stages: the declaration of liability, the assessment and the collection. According to Arden LJ, the term 'taxation' had to be interpreted in its context in the tax treaty and that it must have an autonomous treaty meaning. For that reason, she held that the term could not be interpreted in accordance with U.K. law, with the result that *"it will not automatically involve the trichotomy of liability, assessment and collection"*.

> The position that the words 'the taxation' are not defined in the treaty is remarkable. Art. 3(1)(d) of the treaty provides: *"the term 'tax' means United Kingdom tax or Swiss tax, as the context requires."* Moreover, Art. 2(1)(a) of the treaty states: *"The taxes which are the subject of this Convention are: in the United Kingdom of Great Britain and Northern Ireland: the income tax, the corporation tax, the capital gains tax, the development land tax and the petroleum revenue tax (hereinafter referred to as 'United Kingdom tax')"*. Consequently, Arden LJ's statement that *"the words 'the taxation' are not defined in [the treaty]"* implies that the term 'taxation' is different from the term 'tax'.
>
> According to the Oxford English Dictionary, the noun 'tax' means *"a compulsory contribution to the support of government, levied on persons, property, income, commodities, transactions, etc., now at fixed rates, mostly proportional to the amount on which the contribution is levied"*, while 'taxation' means *"the imposition or levying of taxes (formerly including local rates); the action of taxing or the fact of being taxed; also transf. the revenue raised by taxes"*. Finally, the verb 'to tax' means *"to impose a tax upon; to subject to taxation"*. Consequently, if there is a difference between both nouns, it is that 'tax' refers to the contribution itself, while 'taxation' refers to *"the action of taxing or the fact of being taxed"*.
>
> From that perspective, it seems artificial to decide that 'taxation' is not defined in the treaty: if the noun 'tax' is defined in the treaty, then 'taxation' refers to the action of imposing the tax so defined, or the fact of being subject to that tax. Accordingly, the combination of Art. 3(1)(d) and Art. 2(1)(a) of the treaty implies that when Art. 24(3) is applied to a Swiss resident's PE situated in the U.K., 'the taxation' in that provision refers to the U.K. income tax, corporation tax, capital gains tax, development land tax and petroleum revenue tax.
>
> Nevertheless, the definition of 'the tax' as 'the U.K. tax' (which is limited to the taxes enumerated in Art. 2(1)(a) of the treaty) is not very helpful. The fact that 'the tax' should be understood as 'the U.K. tax' does not mean that domestic U.K. law should be applied when interpreting this concept: the treaty definition does not provide that 'tax' should be given the meaning it has under the domestic law of the State applying the provision. Rather, the term should be given an autonomous treaty meaning, in line with the dictionary definition quoted above. Consequently, 'the taxation' can be defined as *"the imposition or levying of compulsory contributions to the support of government, levied on persons, property, income, etc.; the action of imposing or levying these contributions or the fact of being subject to them."*
>
> On its ordinary meaning, that expression includes liability, assessment and collection of the tax. Not included, however, are the formalities connected with the taxation (see infra).

Arden LJ then notes that Art. 24(1) and (5) both refer to "any requirement connected therewith", while that phrase is absent in the PE non-discrimination clause. According to

[669] Court of Appeal (Civil Division) 21 February 2007, *UBS*, 9 *ITLR* 767, 792.

Arden LJ, this is *“an indication that the expression ‘the taxation’ does not cover all aspects of liability to tax”*. Therefore, the expression may be limited to provisions which impose the tax, as distinct from collateral obligations of the taxpayer, such as the obligation to file a return. She then dismisses the argument that ‘the taxation’ in Art. 24(3) is not limited to provisions which impose tax, because the provision also refers to ‘personal allowances and reliefs’: according to Arden LJ, personal allowances and reliefs are analogous to the expenses of a business which are deducted in the calculation of profits for the purpose of the charge to tax. The right to deduct such expenses is clearly part of ‘the taxation’ on a PE. The credits which a U.K. resident company receives in respect of qualifying distributions are very different from those personal reliefs since they are credits against the mainstream corporation tax of the company paying a dividend and not a relief against the income of the recipient of the dividend.

Then, Arden LJ addresses the argument of the tax authorities that ‘taxation’ means merely the direct burden of tax. This includes the deduction of allowances and reliefs, but only those allowances and reliefs which reduce the charge to tax. In the words of Vogel, ‘taxation’ refers to *“what must be paid in terms of money”*[670]. Arden LJ agrees with this approach. She argues that the decisive question is whether the associated tax credit serves to reduce the liability for tax in the case of U.K. resident companies. The answer to this is that the credit could be used to reduce the amount of ACT which a U.K. resident company paid on subsequent distributions. But a PE cannot make a dividend distribution. Consequently, the appropriate object of comparison here is a U.K. resident company that does **not** distribute dividends[671]. In other words, the U.K. regime could not be considered as less favourable to PEs simply because they could not utilise the tax credit in operations (here, the making of dividend distributions) which they could not carry out[672].

However, the disadvantage at issue here was not that, unlike PEs, resident companies could set off the credit against ACT payable on subsequent distributions. Rather, the disadvantage was that resident companies, unlike PEs, were entitled to a payment of the tax credit in certain circumstances. Particularly, for the purpose of the setting off of trading losses (whether they were carried forward or not), surplus FII could be made to release its tax credit (see supra). In such a case, the surplus FII was treated as profits against which the trading losses could be set off, and the amount of the tax credit comprised in that surplus FII was paid in cash to the company.

The question therefore arises whether this mechanism forms part of ‘the taxation’ for the purpose of Art. 24(3). Arden LJ first points out that s 242(1) ICTA 1988 seems to provide some support for this because it requires the surplus FII to be treated *“as if it were a like amount of profits chargeable to corporation tax”*. Similarly, s 243 ICTA 1988 (concerning losses that have been carried over) provides that the surplus FII *“shall for the purposes of the claim be treated as trading income for the accounting period”*. However, Arden LJ holds that these expressions do not have the effect of making the surplus FII profits, they simply treat

[670] See also Comm. OECD on Art. 24, para. 34: *“it is the result alone which counts.”*
[671] See also supra, 2.D.II.B.b.3.
[672] This argument once again demonstrates that the comparability-test and the disadvantage-test are intertwined. If the object of comparison is a U.K. resident company that distributes dividends, the PE is treated less favourably because, unlike the resident company, it cannot set off the credit against dividends distributed. However, if the object of comparison is a U.K. resident company that does not distribute dividends, the PE is not treated less favourably because both the U.K. resident and the PE are unable to set off the credit against dividends distributed. However, as will be pointed out below, the disadvantage at issue was the **payment** of the credit, rather than the possibility to set it off against distributions made.

them “as if they were profits”. This is merely a drafting technique to enable a limited right to claim payment of surplus FII to be conferred. Accordingly, s 242 and s 243 do not create a liability to tax against which the surplus FII is set. No tax is payable as a result of the offet process, so the tax credit does not reduce the charge to tax. As a result, the claim to relief under s 242 or s 243 does not form part of ‘the taxation’ for the purpose of Art. 24(3).

Put briefly, the expression ‘the taxation’ refers to the tax payable on the profits chargeable to tax less any relief or allowance which reduces it. That does not include the (payment of) the tax credit in this case, as it does not reduce the charge to tax.

Arden LJ then dismisses the argument that the utilisation of the tax credit against losses constitutes ‘taxation’ because it would accelerate the charge to tax if the PE subsequently made profits. In that case, the losses absorbed by the FII could not be set against those profits and tax would become payable earlier. According to Arden LJ, a credit which does not directly reduce the charge to tax but which may possibly have an effect on it at some undefined point in the future does not constitute ‘taxation’ for purposes of Art. 24(3). The payment of the credit under s 242 or 243 ICTA 1988 will, at the moment of payment, have no effect on the current tax bill (and may never have any effect at all on any future tax bill). It is simply a payment equivalent to the ACT originally paid by the company distributing dividends; it is not a credit against any tax paid by the recipient of the dividends.

Finally, she holds that this approach is consistent with Art. 10(3) of the treaty[673]. Under that provision, the general rule is that Swiss residents receiving dividends from U.K. resident companies are entitled to the tax credit to which a U.K. resident individual would have been entitled and to the payment of any excess of that tax credit over his liability to U.K. tax. That rule does not apply where the dividends are paid to a PE of the beneficial owner and the holding in respect of which the dividends are paid is effectively connected with the PE’s business. In that case, the rules of Art. 7 apply[674]. According to Arden LJ, these provisions recognise that a PE is not entitled to set a tax credit against its liability to tax or to the payment of the surplus of the tax credit over its liability to U.K. tax: *“it is hardly possible that the contracting states, having excluded permanent establishments from art 10, intended them to be able to claim to use the tax credit through [Art. 24(3)]. For these reasons, I conclude that [Art. 24(3)] is not engaged in this case”*[675].

Commentary

The core issue in this case is whether the payment of the tax credit constituted ‘taxation’ within the meaning of Art. 24(3). As mentioned earlier, Art. 24(3) does not prohibit Contracting States from subjecting PEs to less favourable formalities, since that provision is only aimed at ‘the taxation’. Consequently, the question here is whether the payment of the credit should be seen as ‘taxation’ or as a ‘formality’ (or as neither of these two).

---

[673] Art. 10(3)(c) of the treaty, as amended in 1981: *“A resident of Switzerland who receives a dividend from a company which is a resident of the United Kingdom shall, subject to the provisions of sub-paragraphs (c) and (d) of this paragraph and provided he is the beneficial owner of the dividend, be entitled to the tax credit in respect thereof to which an individual resident in the United Kingdom would have been entitled had he received that dividend, and to the payment of any excess of that tax credit over his liability to United Kingdom tax.”*
[674] See Art. 10(5) of the treaty, analogous to Art. 10(4) OECD MC.
[675] Court of Appeal (Civil Division) 21 February 2007, *UBS*, 9 *ITLR* 767, 796-797.

First, the measure at issue was not a 'formality connected with the taxation'. As pointed out by the Special Commissioners, the measure was, in a certain sense, a mechanism for securing payment of the tax credit. However, the circumstance in which this occurred was by way of relief for losses. In this respect, the measure is not different in nature from measures allowing losses to be carried forward or backwards.

Secondly, as pointed out by the High Court, the levying of tax is a broad concept. It is possible that tax is 'imposed' or 'levied' but that, ultimately, there may be nothing to be paid. 'Taxation' encompasses all the provisions that determine a taxpayer's tax position, even if that taxpayer ultimately does not pay any tax. From that position, the payment of a tax credit undeniably forms part of the 'taxation' on the PE. Accordingly, interpreting 'taxation' as merely referring to the amount of tax payable on profits (less reliefs or allowances that reduce the charge to tax) is too narrow. The statement in the Commentary that "it is the result alone which counts" does not alter this conclusion. That statement should be read in its context: the Commentary points out that (the PE of) a non-resident is inherently different from a resident, which means that it is sometimes necessary to treat them differently for tax purposes. However, that different treatment must not lead to less favourable taxation. That is the meaning of the statement that "it is the result alone which counts": it is permitted to treat PEs differently, as long as their ultimate tax position is not less favourable. If a U.K. resident is entitled to a payment in respect of the tax credit while a PE cannot, it is clear that the PE's tax position is less favourable.

As to Arden LJ's suggestion that her approach is consistent with Art. 10(3) of the treaty, it should be stressed that this is a separate issue which has little to do with the interpretation of the term 'the taxation' in Art. 24(3). If that term includes the payment of the credit at issue in *UBS*, then Art. 24(3) entitles the taxpayer, in principle, to such payment. However, if the Contracting States have expressly agreed in a different provision of the treaty that PEs are not entitled to such payment, then the non-discrimination provision should yield for this express deviation therefrom[676]. That is not a matter of interpreting the term 'taxation', but simply a matter of giving one treaty provision preference over another in the case of conflict between those provisions (see also 2.D.III.C.e).

d. Credit for foreign tax and the extension to PEs of the benefit of tax treaties concluded with third States

1. Finanzgericht Hamburg 9 August 1985[677]

This is a case involving a credit under domestic law. It does not concern the issue of a credit only being allowed by treaty (which raises the question whether the PE is entitled to the

[676] This point was also addressed by the Special Commissioners, who dismissed the tax authorities' argument as "oversubtle and irrelevant". According to the Special Commissioners, *"Article 10(5) merely disapplies the tax credit provision in that article and applies the business profits article (Art. 7), which in turn brings into play the permanent establishment non-discrimination provision. That is all."* In other words, the Special Commissioners did not consider that Art. 10(5) demonstrated an intention on the part of the Contracting States not to give any relief to a PE based on a tax credit. Consequently, the PE non-discrimination provision should be given full effect.

[677] FG Hamburg 2. Senat, No. II 69/80, *EFG* 1986, 63. See also R. BETTEN, "Non-discrimination clause and the possibility to credit foreign (third country) taxes", *European Taxation* 1986, 320-322.

benefits of a treaty with a third State[678]). Nevertheless, as will become apparent below, the tax treaty between the PE State and the source State did have some effect on the case.

The taxpayer was a Japanese resident company with a PE in Germany, through which it received interest from Argentina and Brazil. The interest payments had been subject to tax at source in Argentina and Brazil. Under the treaties Germany/Argentina and Germany/Brazil, double taxation was avoided in Germany by allowing German residents to credit Argentinian or Brazilian tax paid against their German income tax. Under German domestic law at the relevant time, resident taxpayers could credit the foreign tax due on their foreign-source income against their German tax liability with respect to that income. However, this credit did not apply with respect to income from countries with which Germany had concluded a tax treaty[679]. Nevertheless, another provision of German domestic law stated that foreign taxes could still be credited against the German income tax due on that income if double taxation was not solved despite the presence of a tax treaty[680].

Non-residents were not entitled to a credit under German domestic law. The taxpayer argued on the basis of the PE non-discrimination clause of the Germany/Japan treaty[681] that he should be entitled to a credit in Germany for the taxes withheld at source in Brazil and Argentina.

The Court dismissed the taxpayer's claim. The Court first noted that German residents were entitled to relief from double taxation by virtue of either the Germany/Argentina treaty or the Germany/Brazil treaty. As these residents were entitled to relief under a tax treaty, the unilateral (domestic) measures were not applicable (see supra). Nevertheless, the taxpayer argued that he was entitled to relief because German domestic law provided that residents were entitled to a credit if double taxation was not solved despite the presence of a treaty. The Court dismissed this argument as well[682].

The core issue here is the construction of the object of comparison. According to the Court, the PE should be compared to a resident receiving interest from Brazil or Argentina. Since such a resident is only entitled to relief by virtue of a tax treaty, the PE cannot claim this benefit on the basis of Art. 24(3) (see supra, relative effect of tax treaties). However, the taxpayer makes a different comparison. According to the taxpayer, the PE should be

---

[678] For an example where the taxpayer claimed relief both under a unilateral measure and under a tax treaty, see High Court, Chancery Division, 17 April 1984, *Sun Life Assurance Co of Canada v Pearson* [1984] S.T.C. 461 (see also supra, 2.D.III.B). The taxpayer in that case, a Canadian insurance company with a PE in the U.K., argued that the PE non-discrimination clause was violated because the U.K. tax authorities denied both bilateral relief, available to residents where a tax treaty applied, and unilateral relief, available to residents where no tax treaty applied. The Court recognized that the tax treaty required the unilateral relief to be extended to the PE, while this was not entirely certain for the bilateral relief. However, the Court ultimately decided that the PE was not entitled to any relief because the domestic law giving effect to the tax treaty did so *"subject to the provisions of this Part of this Act"*. As one of the provisions of the relevant Part of the Act was that credit was only granted to residents, the restriction was held to override the treaty provision. As a matter of domestic law, that conclusion is certainly correct, but it seems difficult to reconcile with Article 27 of the Vienna Convention. As regards the problem in the U.K. that the non-discrimination provision is sometimes not given effect because of overriding provisions of domestic law, see also *Commerzbank* (2.D.III.C.a.2), *UBS* (2.D.III.C.c.1) and *Boake Allen* (2.F.II.D.d).

[679] Sec. 34(c)(1) and (2) EstG.

[680] Sec. 68g Income Tax Ordinance 1975.

[681] Art. 24(2) of the 1966 treaty between Germany and Japan, which corresponds to Art. 24(4) of the 1963 OECD Draft Convention.

[682] According to the Court, the PE non-discrimination clause did not require Germany to grant the PE a credit, irrespective of whether the German unilateral measures for the avoidance of double taxation could be considered as 'personal benefits' under the second sentence of Art. 24(3).

compared to a German resident who is **not** entitled to relief under the treaty and who is, consequently, entitled to the credit under domestic law. The Court, however, does not make that comparison.

The Court then verified whether the taxpayer was entitled to relief in his State of residence, Japan. The Court found that Japanese domestic law allowed the taxpayer to credit the Argentinian and Brazilian taxes withheld at source. Moreover, the tax levied in Germany in respect of the PE could also be credited in Japan against Japanese income tax: Art. 23(2) of the Germany/Japan treaty provided that "*German tax payable, whether directly or by deduction, in accordance with the provisions of this Agreement shall be allowed as a credit against Japanese tax*". In this context, the Court held that it was unlikely that the German tax was not levied in accordance with the provisions of the Germany/Japan treaty. As the treaty did not contain a provision dealing with withholding taxes levied in third countries, it could not be said that the German tax, which was due because of the refusal in Germany of a credit for foreign tax, was not levied in accordance with the provisions of the treaty.

Furthermore, the Court noted that the treaty Japan/Brazil did not limit its scope of application as regards interest paid to a Japanese resident's PE situated in a third country. Consequently, the Brazilian withholding tax levied at source could be credited against the Japanese tax due by virtue of Art. 22(2)(a) of the treaty Japan/Brazil[683]. There was no treaty between Japan and Argentina, but the tax levied at source in Argentian could be credited in Japan by virtue of the provisions of domestic Japanese law (see supra). As a result, the taxpayer could credit the Argentinian and Brazilian tax withheld at source against its Japanese tax due, either under domestic law or under the treaty Japan/Brazil. From this, the Court concluded that the absence of a credit in Germany was not discriminatory: because the taxpayer could credit both withholding taxes against his Japanese income tax, the income of the PE was not taxed less favourably in Germany than similar income of a German resident. Furthermore, it was not relevant in the Court's opinion whether the taxpayer actually credited the withholding tax against his Japanese income tax.

Granting a credit in Germany would even lead to a better treatment of Japanese taxpayer with a PE in Germany as compared to German residents. According to the Court, this could not have been intended by the PE non-discrimination clause of the treaty Germany/Japan.

While this judgment can be seen as supporting the position that Art. 24(3) does not entitle the PE to relief mechanisms provided for under a tax treaty between the PE State and the third State (which, in my opinion, is the correct interpretation of Art. 24(3): see hereafter), it could be said that the case actually concerned the PE's entitlement to **domestic** relief measures. It is essential here that domestic law provided for a relief mechanism insofar as double taxation was not removed under a tax treaty. The general rule in this respect is that PEs are entitled to the benefit of this mechanism in the same way as residents. The problem, of course, was that the domestic regime only applied if the taxpayer was not entitled to relief under a tax treaty. However, because the scope of application of tax treaties is, as a general rule, limited to residents of the Contracting States, a PE is by its very nature not entitled to the benefits of a tax treaty. Consequently, the non-entitlement to the treaty is an element which is inextricably bound up with the PE's nature as a 'part' of a non-resident taxpayer. As mentioned earlier,

---

683 "*Where a resident of Japan derives income from Brazil which may be taxed in Brazil in accordance with the provisions of this Convention, the amount of the Brazilian tax payable in respect of that income shall be allowed as a credit against the Japanese tax imposed on that resident. The amount of credit, however, shall not exceed that part of the Japanese tax which is appropriate to that income.*"

characteristics which are indissoluble from the comparative attribute should be left out of the analysis. For instance, characteristics which are inseparable from a taxpayer's nationality should be left out of the analysis under Art. 24(1). If not, States could adapt their discriminatory laws by attaching the discriminatory treatment to that characteristic instead of the prohibited criterion of nationality[684]. Similarly, the comparative attribute here is the non-residence of the non-resident taxpayer having a PE in the PE State. The non-entitlement to benefits in treaties between the PE State and a third State is indissoluble from the comparative attribute, non-residence. As a result, it cannot be said that the fact that residents are entitled to relief under a tax treaty while the PE is not, renders the situations incomparable. Therefore, the comparison had to be made between the taxpayer's PE (subject of comparison) and a German resident taxpayer who was not entitled to relief under a tax treaty (object of comparison). As the object of comparison is entitled to relief from double taxation under domestic law, Art. 24(3) requires Germany to extend this relief to the subject of comparison.

> The situation described here is not the same as the situation where **the discrimination itself** consists in the non-entitlement to treaty benefits (for instance where the relief provision at issue is laid down exclusively in the tax treaty PE/Y; i.e. a typical triangular case). Obviously, the non-entitlement to the treaty should also be left out of the comparability analysis in that case, but for different reasons: the non-entitlement to treaty benefits is exactly the differential treatment at issue. If that characteristic were considered to render the situations incomparable, then Art. 24 would be of little use. However, the situation explained here illustrates why triangular cases fit uneasily within the framework of Art. 24(3): the discrimination at issue (the non-entitlement to treaty benefits) is indissoluble from the comparative attribute (the non-residence in the PE State).

Furthermore, the Court's reference to the availability of credits in Japan is not convincing. As mentioned earlier, Art. 24(3) is only concerned with the discrimination in the PE State. What happens in the residence State (Japan) should be irrelevant[685]. It is important to remember that the non-discrimination Article is a special provision in the framework of the OECD MC. Unlike most other provisions, Art. 24 is not intended to prevent or alleviate double taxation. The purpose of Art. 24 is to remove discriminatory treatment. In many cases, the discrimination at issue will involve some sort of double taxation (particularly where measures intended to alleviate double taxation are applied in a discriminatory manner), but that is not essential to Art. 24. What the Court seems to suggest is that there is no double taxation – because a credit is granted in Japan – with the result that Art. 24 has not been violated. However, the absence of double taxation (from the perspective of the taxpayer's overall position) is irrelevant for the application of Art. 24. What is at stake is whether Germany discriminates against non-residents having a PE in Germany. The fact that the disadvantage

---

[684] As discussed earlier, this is not the same as indirect discrimination (which goes beyond the scope of Art. 24). Moreover, it should be stressed that domestic law provisions are fundamentally different from tax treaty provisions. The latter are the result of bilateral negotiations and inherently reciprocal in nature. Therefore, even if a domestic provision is identically drafted to a tax treaty provision, or even if the scope of a domestic provision is defined by referring to a tax treaty provision, it still is a domestic law provision. As a result, Art. 24(3) requires the PE State to extend the benefit of such domestic provisions to the PE of a resident of the other Contracting State. The situation is different for tax treaty provisions: as these are inherently reciprocal in nature, the balance of the treaty would be upset if the PE State were required to extend them to third State residents (see also Part III, 2.E.I.A.a.1.e, on the ECJ's decision in *Saint-Gobain*).

[685] See also J. AVERY JONES, "The non-discrimination Article in tax treaties: Part 2", *British Tax Review* 1991, 434.

due to the discriminatory treatment in the PE State is ultimately removed in the residence State does not mean that the discrimination in the PE State is removed[686].

2. Dutch Supreme Court 8 February 2002[687]
a. The Court's decision

The taxpayer, a company resident in the Netherlands with a PE in Switzerland, owned intellectual property in respect of which it derived royalties. 90% of the taxpayer's activities (and, hence, 90% of the royalties) was allocable to the PE. In the year at issue, the taxpayer earned f 1,220,466 in royalties from Japan. Upon payment, a 10% source tax was withheld in Japan in accordance with Art. 13(2) of the 1970 Dutch/Japanese treaty, totalling f 122,047.

The taxpayer claimed relief for the full amount of Japanese tax withheld at source. The Dutch tax authorities dismissed this claim, arguing that only 10% of the Japanese source tax could be credited in the Netherlands (because only 10% of the royalties were not allocated to the PE), resulting in a credit of f 12,204.

The treaty between **the Netherlands and Japan** did not address the situation where the royalties were paid to a PE which the taxpayer has in a third State. Art. 24(2) of that treaty provided how relief from double taxation was given in the Netherlands:

"(a) The Netherlands, when imposing tax on its residents, may include in the basis[688] upon which such tax is imposed the items of income, which according to the provisions of this Convention may be taxed in Japan. […]
(c) Further the Netherlands shall allow a deduction from the Netherlands tax so computed for such items of income, as are included in the basis meant in the provisions of sub-paragraph (a) and as may be taxed in Japan according to the provisions of [Article 13(2)]. The amount of this deduction shall be equal to the amount of the Japanese tax. The deduction shall not, however, exceed that part of the Netherlands tax as computed before the deduction is given which is appropriate to the said items of income."

Consequently, this provision required the Netherlands to grant a credit for the royalties derived from Japan, subject to two limits: (1) the amount of Japanese tax levied at source and (2) the part of Dutch tax that could be proportionally attributed to the royalties as computed before the deduction.

---

686 Similarly, M. LANG, J. LUDICKE and P. RIEDWEG, "Steueranrechnung und Betriebsstättendiskriminierungsverbot der DBA bei Dreieckssachverhalten", *IstR* 2006, 75: *"Das FG Hamburg verkannte den Sinn des Diskriminierungsverbotes: Ziel der Regelung ist es,* ***im Betriebsstättenstaat*** *Diskriminierungen zu verhindern. Daher kann ein Steuervorteil in einem anderen Staat eine Diskriminierung im ersten Staat nicht rechtfertigen. Auch geht es dem Betriebsstättendiskriminierungsverbot nicht um die Vermeidung von Doppelbesteuerung, sondern um die Gleichbehandlung von ausländischen Unternehmen mit Betriebsstätten im Inland und inländischen Unternehmen. Daher kann eine Doppelanrechnung von Einkünften – in Deutschland und in Japan – im Hinblick auf die Zielsetzung der Regelung auch nicht als überschießend angesehen werden"* (emphasis in original text). See also the decision of the Austrian Verwaltungsgerichtshof of 16 February 2006, discussed in 2.D.II.B.a.6, where the Court suggested that it would be justified to deny loss deductibility at the PE level if there was a risk that the loss could also be taken into account at the level of the head office.
687 Hoge Raad 8 February 2002, No. 36155, *BNB* 2002/184c.
688 In point 3 of the Protocol, the 'basis' was defined as *"the gross income or profits in terms of the Netherlands income tax law or company tax law, respectively"*.

Under the 1951 treaty between **the Netherlands and Switzerland**, the Netherlands retained the right to include the profits of the PE in the taxable base, but it deducted from the Dutch tax calculated on the taxpayer's worldwide income the portion of Dutch tax that corresponded proportionally to the ratio of the PE income to the worldwide income[689].

The 1971 treaty between **Switzerland and Japan** followed the 1963 OECD MC. Neither the taxpayer, nor its Swiss PE was a resident of either State, which meant that this treaty did not apply to the Japanese royalties. Accordingly, this treaty did not require Switzerland to grant relief to the taxpayer in respect of the source tax levied in Japan.

Before the Supreme Court, the taxpayer argued that the Netherlands, as the taxpayer's State of residence, was required to grant a credit for the Japanese source tax, while at the same time exempting the PE profits[690]. The Court dismissed this argument. According to the Court, it is up to the PE State (Switzerland) to remove the disadvantage[691]. This approach implies that the PE non-discrimination clause in the treaty between **the Netherlands and Switzerland** requires Switzerland to extend the relief granted under the treaty Switzerland/Japan to residents of the Netherlands with a PE in Switzerland (i.e. to equate that PE with a Swiss resident as regards entitlement to those treaty benefits)[692].

In other words, the Court implicitly decides that, in a triangular situation, Art. 24(3) requires the PE State to extend to the PE of a taxpayer resident in the other Contracting State the relief it grants to its residents under the treaty with the source State.

---

[689] See point 3(3) of the Final Protocol and the Resolution of the Dutch State Secretary for Finance of 10 May 1955, *BNB* 1955/195. As this treaty dates from 1951, it deviates somewhat from the OECD MC (see e.g. O. KROON, "Hoge Raad 8 februari 2002: de goede trouw jegens de bronstaat, non-discriminatie en dubbele belasting in een triangular case", *MBB* 2002/236). These differences, and the more general question whether the Comm. OECD can be used when interpreting the treaty, will not be addressed here.

[690] From the perspective of the Netherlands, the question therefore boils down to whether the taxpayer's State of residence is required to grant relief both for the PE profits (exemption) and for the full amount of the royalties (credit). As this issue does not concern discrimination, it will not be discussed here (for an overview, see e.g. T. BENDER and F. ENGELEN, "Hinken op twee gedachten in een driehoekssituatie", *WFR* 2002/1461; M. DE WILDE, "Over samenloop van verrekening en vrijstelling onder belastingverdragen; de Hoge Raad oordeelt opnieuw in een triangular case", *WFR* 2007/855; A. VAN DE VIJVER, "Over een triangulaire casus en de intrusie van het Europees recht bij de interpretatie van dubbelbelastingverdragen", *T.F.R.* 2008, 342, 523-536). The remainder of the discussion will focus on the PE State, as this is where the discrimination issues arise. The Supreme Court confirmed its decision as regards the obligations of the Netherlands, as the taxpayer's State of residence, in Hoge Raad 11 May 2007, No. 42385 (*Vakstudie Nieuws* 2007/24.9). In that case, the Supreme Court once again took the position that it is up to the PE State to grant the credit. However, the taxpayer in that case was a resident of the Netherlands with a PE in Belgium. Consequently, the Court's assessment of the obligations of the PE State was based entirely (and correctly) on *Saint-Gobain*. Therefore, no attention was given to discrimination under the applicable tax treaty.

[691] *"Een verrekening van de over dit gedeelte van de royalty's ingehouden bronbelasting met de in Nederland verschuldigde vennootschapsbelasting […] zou ook niet sporen met het streven verrekening van de buitenlandse bronheffing te laten plaatsvinden met de belasting die de vaste inrichting verschuldigd is in het land waarin deze zich bevindt"* (para. 3.6 of the judgment, referring to the ECJ's decision in C-307/97, *Saint-Gobain*)

[692] The Advocate-General had reached the same conclusion: see paras. 7.1-7.9 and 9.12 of the Opinion. As a side note, it should be mentioned that Switzerland traditionally does not follow this interpretation of Art. 24(3) (see P. LOCHER, *Einführung in das internationale Steuerrecht der Schweiz – 3. Auflage*, Bern, Stämpfli Verlag, 2005, 513-514). As a result, the Swiss PE was not entitled to relief in Switzerland under the PE non-discrimination clause of the Dutch/Swiss treaty.

b. Conclusion
1. Reference to Saint-Gobain

The Dutch State Secretary for Finance has confirmed the Supreme Court's approach in a Regulation of 21 January 2004[693]. According to the Regulation, where a non-resident taxpayer has a PE in the Netherlands, the tax treaty with the taxpayer's State of residence requires the Netherlands to credit the source tax on dividends, interest and royalties allocable to the PE if a resident taxpayer is entitled to relief in the Netherlands either under domestic law or under a tax treaty with the source State[694]. If there is no tax treaty between the Netherlands and the taxpayer's State of residence, the PE is not entitled to a credit in the Netherlands.

The Regulation then notes that the credit granted to the PE is limited to the lowest of (1) the tax calculated on the basis of the rate provided for in the treaty between the Netherlands and the source State and (2) the tax calculated on the basis of the rate provided for in the treaty between the taxpayer's State of residence and the source State[695]. The maximum amount to be credited is the tax effectively levied at source, unless where the treaty between the Netherlands and the source State provides for a tax sparing credit. In the latter case, a credit is granted up to the amount of the tax sparing credit, unless this amount is higher than the second limit referred to above (i.e. the tax calculated on the basis of the rate provided for in the treaty between the taxpayer's State of residence and the source State)[696].

Finally, the Regulation provides that the same conditions and rules apply as to a resident of the Netherlands. Consequently, the credit is only granted if the dividends, interest or royalties form part of the taxable basis of the PE in respect of which tax is effectively levied in the

[693] No. IFZ2003/558M, *BNB* 2004/134.
[694] *"Indien Nederland een belastingverdrag – hieronder wordt in dit besluit elke wederkerige regeling ter voorkoming van internationale dubbele belasting verstaan – is overeengekomen met het land waar de buitenlands belastingplichtige gevestigd is, keur ik het volgende goed. De verrekening van bronbelasting bij een vaste inrichting van deze buitenlands belastingplichtige zal onder dezelfde voorwaarden plaatsvinden als de verrekening van bronbelasting voor de buitenlands belastingplichtige met een vaste inrichting in Nederland die toegang heeft tot een verdrag dat de vestigingsvrijheid garandeert zoals hiervoor onder paragraaf 2 omschreven."* The credit is granted *"in the same conditions as in the situation where the non-resident has a PE in the Netherlands and is entitled to the credit by virtue of the EC freedom of establishment"*, that is to say that the credit is only granted *"if a resident taxpayer in receipt of dividends, interest or royalties would be entitled to a credit in the Netherlands by virtue of an (international) measure for the prevention of double taxation"* (*"deze verrekening is alleen mogelijk indien in het geval dat een binnenlands belastingplichtige persoon de dividenden, interest of royalty's zou ontvangen, deze persoon voor de verrekening van in het bronland geheven belasting in Nederland een beroep op een (internationale) regeling ter voorkoming van dubbele belasting zou kunnen doen"*).
[695] If there is no treaty between those two States that limits the amount of tax to be withheld at source, then the domestic withholding tax rate of the source State is used as the starting point for this calculation.
[696] *"De verrekening van bronbelasting op dividenden, interest en royalty's bij de vaste inrichting is beperkt tot de laagste van: (a) de belasting berekend naar het percentage overeengekomen in het belastingverdrag tussen Nederland en het land van waaruit de dividenden, interest of royalty's afkomstig zijn; en (b) de belasting berekend naar het percentage overeengekomen in het belastingverdrag tussen het land van vestiging van de buitenlands belastingplichtige met een vaste inrichting in Nederland en het land van waaruit de dividenden, interest of royalty's afkomstig zijn.[…] Er kan niet meer belasting worden verrekenend dan de daadwerkelijk geheven buitenlandse belasting. De enige uitzondering hierop is het geval waarin als gevolg van het belastingverdrag tussen Nederland en het land van waaruit de dividenden, interest of royalty's worden betaald rekening kan worden gehouden met een zogenaamde 'tax sparing credit'. Alsdan kan tot het bedrag van de tax sparing credit verrekening plaatsvinden, tenzij dit bedrag hoger is dan de onder b berekende belasting."*

Netherlands. The credit cannot exceed the Dutch tax levied in respect of the dividends, interest or royalties[697].

It is interesting to note that both the decision of the Supreme Court and the State Secretary's Regulation refer to the ECJ's *Saint-Gobain* judgment when interpreting Art. 24(3). As neither explains why *Saint-Gobain* is relevant for the interpretation of the tax treaty PE non-discrimination clause, it is unclear what the purpose of this reference is. If that reference is a mere analogy between Art. 24(3) and the ECJ's application of the Treaty freedoms in *Saint-Gobain* (i.e. that, coincidentally, both the treaty freedoms and Art. 24(3) cover benefits provided for in treaties with third States), then it is not very convincing.

The ECJ's *Saint-Gobain* judgment is based on the principle that, because of the specific supra-national legal order it has created, European law has priority over domestic tax provisions and over tax treaties concluded between Member States[698]. It is settled case law that, in the context of removing double taxation within the EU, no harmonisation has been realised yet. As a result, the allocation of taxing rights and the determination of methods for the avoidance of double taxation is entirely a matter for the Member States[699]. However, as far as the **exercise** of the power of taxation so allocated is concerned, Member States may not disregard EU law. That is what happened in *Saint-Gobain*: the tax treaty allocated the power to tax to Germany (and this allocation goes beyond the scope of EU law), but Germany's **exercise** of the power so allocated had to be in accordance with the non-discrimination principle expressed in the fundamental freedoms. And, in the present case, this exercise consisted in granting residents a credit for tax paid abroad, while denying it to PEs of non-residents[700]. As this exercise constituted discrimination, the Court held it to be contrary to the fundamental freedoms.

This line of reasoning cannot be transposed to Art. 24(3) OECD MC as it has traditionally been understood. Underlying the decision in *Saint-Gobain* was the principle of primacy of EU law. Insofar as a matter comes within the scope of the EU Treaties, Member States must respect the provisions of those treaties, including the prohibition of discrimination underlying the free movement provisions. Consequently, where a situation is governed by EU law, Member States must refrain from discriminatory treatment, irrespective of whether this treatment results from national law or tax treaty law[701]. As mentioned before, situations fall

[697] *"De vaste inrichting kan de bronbelasting op dividenden, interest of royalty's waarvoor in Nederland een (internationale) regeling ter voorkoming van dubbele belasting bestaat verrekenen met inachtneming van de normale regels zoals die gelden bij de verrekening van de buitenlandse belasting voor in Nederland gevestigde lichamen. Dit houdt onder andere in dat vereist is dat de dividenden, interest of royalty's tot de grondslag van de vaste inrichting behoren waarover feitelijk Nederlandse belasting wordt geheven. De verrekening van de buitenlandse belasting bedraagt nooit meer dan de Nederlandse belasting over de dividenden, interest of royalty's."*

[698] Legal writing on this issue is abundant. See e.g. L. HINNEKENS, "Compatibility of bilateral tax treaties with European Community law. The rules", *EC Tax Review* 1994, 4, 146 *et seq.*; M. LANG, "The binding effect of the EC fundamental freedoms on tax treaties", in W. GASSNER, M. LANG and E. LECHNER, *Tax treaties and EC law*, London, Kluwer Law International, 1997, 15-31; P. FARMER, "EC law and double taxation agreements", *EC Tax Journal* 1999, 3, 137 *et seq.*; F. VANISTENDAEL, "Impact of European tax law on tax treaties with third countries", *EC Tax Review* 1999, 3, 165 *et seq.*

[699] E.g. C-336/96, *Gilly*, § 30 *et seq*. See also Part III, 2.E.II.C.

[700] C-307/97, *Saint-Gobain*, § 57-58.

[701] This is also true for tax treaties concluded between a Member State and a third country. See, in particular, Art. 4(3) TEU: *"The Member States shall take any appropriate measure, general or particular, to ensure fulfilment of the obligations arising out of the Treaties or resulting from the acts of the institutions of the Union. The Member States shall facilitate the achievement of the Union's tasks and refrain from any measure which could jeopardise the attainment of the Union's objectives"* and Art. 351 TFEU: *"The rights and obligations arising*

outside the scope of EU law where the Member States have retained their sovereignty. And, in the context of tax treaties, this is where the distinction between allocating taxing powers and exercising those powers is decisive. Matters relating to the allocation of taxing powers fall outside the scope of EU law, with the result that the prohibition of discrimination underlying the Treaty freedoms does not affect these matters. In contrast, where Member States exercise the powers so allocated, they must respect the non-discrimination principle, regardless of whether they exercise these powers in their national law or in a bilateral treaty.

As this line of reasoning cannot be transposed to the traditional interpretation of Art. 24(3) OECD MC, the conflict arising where a tax treaty provision constitutes discrimination contrary to the non-discrimination provision of another tax treaty should be resolved under the general rules on the interpretation of tax treaties. Given the principle of reciprocity (and the resulting relative effect of tax treaties), it seems clear that Art. 24 does not offer a solution for such conflicts. So the reference to *Saint-Gobain* can not be read as a mere analogy. For that reason, it is more plausible that the Dutch Supreme Court gave an extensive interpretation to Art. 24(3) because it was influenced by the ECJ's case law (see Part IV, 2.B.I.A.c).

<u>2. Does Art. 24(3) cover benefits provided for in a treaty with a third State (irrespective of influence of the ECJ's case law)?</u>

Even if any possible influence from the ECJ's case law on the interpretation of Art. 24 is disregarded, several authors have taken the position that Article 24(3) of treaty R/PE requires State PE to extend the relief granted under its treaty with State Y to the PE of a State R resident[702]. They argue that Art. 24(3) only refers to "a resident enterprise of the PE State carrying on the same activities". Accordingly, the object of comparison is not limited to a resident who derives benefits exclusively from the application of domestic law. The legal framework to be taken into account when constructing the object of comparison should be that applied to a resident carrying on the same activities as the PE, including provisions of tax treaties. A resident carrying on such activities would also receive income from State Y, which would mean that its tax situation would be affected by treaty PE/Y. Since Art. 24(3) does not specify that this aspect of the object of comparison's legal position should be left out of the equation, there is no reason to assume that relief granted under a tax treaty falls outside of the scope of the non-discriminatory treatment to which the PE is entitled.

---

from agreements concluded before 1 January 1958 or, for acceding States, before the date of their accession, between one or more Member States on the one hand, and one or more third countries on the other, shall not be affected by the provisions of the Treaties. To the extent that such agreements are not compatible with the Treaties, the Member State or States concerned shall take all appropriate steps to eliminate the incompatibilities established. Member States shall, where necessary, assist each other to this end and shall, where appropriate, adopt a common attitude […]" The necessity of a transitional provision to exempt treaties concluded before the entry into force of the EU Treaties can only be explained (a contrario) if there is a primary obligation to ensure compatibility with EU law of such treaties concluded after that date. Moreover, the transitional exemption for treaties concluded before the entry into force of the Treaties is not absolute, as Member States are required to *"take all appropriate steps to eliminate the incompatibilities established"*. See also the Opinion of Advocate-General Mancini in C-270/83, *Avoir fiscal*, § 8: *"Under Articles [351 TFEU] and [4(3) TEU], international agreements concluded after the entry into force of the Treaty may not contain provisions incompatible with it"* and L. HINNEKENS, *o.c.*, 156.

[702] F. GARCIA PRATS, "Triangular cases and residence as a basis for alleviating international double taxation. Rethinking the subjective scope of double tax treaties", *Intertax* 1994, 11, 479-481; K. VAN RAAD, "Triangular cases", *European Taxation* 1993, 299; B. PEETERS, "On anti-discrimination provisions and permanent establishments in bilateral triangular situations", in L. HINNEKENS and P. HINNEKENS, *A vision of taxes within and outside European borders. Festschrift in honor of Prof. Dr. Frans Vanistendael*, 2008, Kluwer Law International, Alphen aan den Rijn, 675.

As a second argument, these authors refer to the Vienna Convention. Article 30 VC governs the situation where successive treaties relate to the same subject matter. According to that provision, when the parties to the later treaty do not include all the parties to the earlier one, as between a State party to both treaties and a State party to only one of the treaties, the treaty to which both States are parties governs their mutual rights and obligations (Art. 30(4)(b) VC). In the present case, treaty R/PE governs the mutual rights and obligations of States R and PE. Moreover, Art. 26 VC provides that every treaty in force is binding upon the parties to it and must be performed by them in good faith. Finally, a treaty between two parties cannot be terminated or suspended by a later treaty concluded by one of those parties and a third party (Art. 59 VC). Put briefly, the PE State cannot invoke the limited effect of treaty PE/Y in order to limit its obligations under treaty R/PE. As a result, State PE is required to extend the benefits of treaty PE/Y to the PE of a State R resident.

Finally, the authors advocating this position contend that the conferral of these benefits to the PE does not imply an extension of the subjective scope of treaty PE/Y. Rather, the taking into account of the effect of treaty PE/Y is a consequence of the requirements of the object of comparison under Art. 24(3). It is only by virtue of treaty R/PE that these benefits are conferred to the PE. If there was no treaty between States R and PE, the PE would not be entitled to these benefits. This is illustrated by the fact that no obligations are imposed on the source State Y. If the subjective scope of treaty PE/Y were really extended, then State Y would have to limit its withholding rates according to treaty PE/Y (rather than applying the rates provided for in treaty R/PE). But that does not happen here: Art. 24(3) of treaty R/PE does not entail any obligation for State Y whatsoever.

The first of these arguments is not convincing. The reason why Art. 24(3) fails in these cases is not because treaty PE/Y is disregarded when constructing the object of comparison. On the contrary, if treaty PE/Y would not be taken into account, there would be no discrimination at all: if the object of comparison were constructed by only taking account of benefits applicable by virtue of domestic law, then the object of comparison would not be entitled to relief either with the result that no discrimination arises. However, it cannot be said that the entitlement to treaty benefits is one of the characteristics which must be shared by object and subject of comparison for there to be comparability. The non-entitlement to treaty benefits is precisely the disadvantage of which the subject of comparison is complaining: the object of comparison **is** entitled to the treaty benefits, while the subject of comparison **is not**. If that characteristic is taken into account in determining comparability, then Art. 24 would be rendered meaningless. As a result, is that the disadvantage at issue (i.e. the fact that the object of comparison is entitled to treaty benefits, while the subject of comparison is not) is not a characteristic that determines comparability. But that does not mean that the effects of the PE/Y treaty are left out of the analysis altogether.

In other words, the problem does not concern comparability, but the scope of application of Art. 24. The comparability-test here is not different from the comparability-test where domestic relief measures are concerned. However, the point is that one does not arrive at the comparability-test if Art. 24 cannot be applied. If benefits under a treaty with a third State are not among the benefits in respect of which Art. 24 seeks to ensure non-discriminatory treatment, then there is no need for a comparability-analysis. And the question as to whether Art. 24 can give entitlement to such treaty benefits, is a general question of treaty interpretation.

That brings us to the second argument referred to above. That second argument starts from the assumption that there is a conflict between treaty PE/Y and treaty R/PE. More specifically, the idea underlying that argument is that State PE is required under the PE non-discrimination provision of treaty R/PE to extend benefits provided for in tax treaties with third States. So when State PE concludes treaty with State Y, restricting the benefits contained therein to residents of both States, a conflict arises between treaty PE/Y and treaty R/PE. In order to resolve this conflict, the authors in question apply the general rules of treaty application, in particular Arts. 26, 30 and 59 VC. But the assumption on which this argument is based is incorrect. The PE non-discrimination clause of treaty PE/Y did not cover benefits contained in treaties with third States to begin with. So there is no conflict between the two treaties. Benefits provided for in treaties with third States do not fall under the 'national treatment' to which the PE is entitled under the non-discrimination clause (more specifically, such benefits should not be taken into account when determining to which treatment the object of comparison – a resident enterprise – is entitled). Accordingly, there is no need to give priority to one treaty over the other.

Finally, the third argument was that conferring benefits provided for in treaty PE/Y to residents of State R with a PE in State PE does not mean that the subjective scope of treaty PE/Y is extended. Rather, it is by virtue of Art. 24(3) treaty R/PE that those benefits are extended to the PE. If the subjective scope of treaty PE/Y were actually extended, then new conditions would also be imposed on State Y (in particular with respect to withholding taxes). That argument is based on an overly restrictive interpretation of the concept of reciprocity. That concept does not only imply that a treaty between State PE and State R cannot create obligations for State Y, but also that the benefits provided for in treaty PE/Y are the result of an agreement between State PE and State Y, involving negotiations and mutual concessions, which means that those benefits are inherently limited to residents of the two States involved (assuming that the treaty's scope is restricted to residents, in accordance with Art. 1 OECD MC). So the fact that no new obligations are imposed on State Y is beside the point. The actual issue here is that State PE and State Y have agreed to mutually grant certain benefits to their respective residents. The balance of that agreement would be upset if residents of a third State could invoke those benefits by invoking the PE non-discrimination clause of the treaty between that third State and State PE.

e. Disadvantages caused by the treaty of which Art. 24(3) is invoked

1. Metchem Canada Inc[703]

The taxpayer was a Canadian company with a PE in India. In his tax return in India, the taxpayer claimed a deduction relating to expenses of the head office in Canada. However, under Indian tax law, the possibility for an Indian PE to deduct expenditures relating to its non-resident head office was limited. This domestic restriction was preserved in Art. 7(4) of the 1985 Canadian/Indian treaty, which read as follows: "*In the determination of the profits of a permanent establishment, there shall be allowed those deductible expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses, whether incurred in the State in which the permanent establishment is situated or elsewhere* ***as are in accordance with the provisions of and subject to the limitations of the taxation laws of that State***" (emphasis added). The Indian

[703] Mumbai Income Tax Appellate Tribunal 30 September 2005, *Metchem Canada Inc v Deputy Commissioneer of Income Tax*, 8 *ITLR* 1043.

tax authorities dismissed the deduction, but the taxpayer claimed that the domestic restriction discriminated against PEs of non-residents[704].

The Court first referred to the observation in the Comm. OECD, that, with regard to the basis of assessment of tax, Art. 24(3) implies that *"permanent establishments must be accorded the same right as resident enterprises to deduct the trading expenses that are, in general, authorised by the taxation law to be deducted from taxable profits in addition to the right to attribute to the permanent establishment a proportion of the overheads of the head office of the enterprise. Such deductions should be allowed without any restrictions other than those also imposed on resident enterprises"*[705]. The Court inferred from this observation that, in addition to the deduction of normal business expenditures of the PE, the scope of Art. 24(3) includes the deduction of a proportion of head office expenditures, without any restriction other than those imposed on resident enterprises.

Consequently, the Court held that placing a restriction on the deduction on account of overheads of the head office constituted discrimination under Art. 24(3), except when the same restriction was also placed on resident enterprises. As no such restriction applied for the deduction of head office expenditures of Indian residents (who could deduct all the legitimate business expenses), the domestic legislation treated PEs of non-residents less favourably than residents carrying on the same activities.

The Court then addresses the preservation of the domestic restriction in Art. 7(4) of the treaty. In this regard, the Court notes that Articles 24 to 28 of the treaty are grouped under 'Chapter VI. Special provisions', whereas the provisions of Articles 6 to 21 are contained in 'Chapter III. Taxation of income'. According to the Court, this meant that the provisions of Art. 24 were specific provisions (in particular, the specific provision that PEs of non-residents should not be discriminated against), whereas the provisions of Art. 7 were general provisions (in particular, the general principles on the basis of which business profits were to be computed). On the basis of the principle *generalia specialibus non derogant*, the Court therefore concludes that the provisions of Article 7, being general in nature, are required to be read as subject to the provisions of Article 24. As a result, the preservation of the domestic restriction in Art. 7 of the treaty had to be disregarded, as this provision was subject to the more specific non-discrimination provision of the treaty.

As mentioned earlier (see 2.B.VI.D.b, on the 1972 decision of the Dutch Supreme Court), where the treaty partners have expressed their desire to deviate from the treaty's non-discrimination standard, it is impossible to argue that this deviation amounts to discrimination under Art. 24[706]. The Court in *Metchem Canada* takes the opposite approach and decides that the tax treaty non-discrimination provisions can be violated by other treaty provisions, precisely because the former are more specific than the latter.

It is difficult to reconcile this position with the observation in the Commentary that the provisions of Article 24 must be read in the context of the other Articles of the treaty *"so that measures that are mandated or expressly authorized by the provisions of these Articles cannot be considered to violate the provisions of the Article even if they only apply, for example, as*

[704] Article 24(2) of the treaty, which was identical to the first sentence of Art. 24(4) of the 1977 OECD MC.
[705] Comm. OECD on Art. 24, para. 40.
[706] See also the *Sun Life*-case, discussed in 2.D.III.B, where it was held that the application to PEs of an apportionment method in line with Art. 7(4) OECD MC is not contrary to Art. 24(3).

regards payments to non-residents"[707]. The other provisions of the treaty clearly form part of the context which must be taken in to account when interpreting Art. 24[708]. The context of the treaty, along with other elements such as its object and purpose and the ordinary meaning of the terms used, serves to find the intention of the treaty partners when drafting the treaty. In the present case, it seems clear that the treaty partners intended to apply the domestic limitations on the deductibility for a PE of expenses relating to the head office, thereby bypassing the non-discrimination provision. As it was the intention of the Contracting States to set aside the non-discrimination provision, the taxpayer's claim on the basis of Art. 24 should have been dismissed.

2. Brussels Court of First Instance 9 November 2006[709]

An Indian company had a PE in Belgium through which it received Indian-sourced interest. Belgian domestic tax law provides for a tax credit for foreign source interest if it has been effectively taxed in the source country (*forfaitair gedeelte van buitenlandse belasting* / *quotité forfaitaire d'impôt étranger*; hereafter: QFIE)[710]. Under domestic law, the QFIE also applies to non-residents with a PE in Belgium through which they receive foreign source income.

In the case at issue, the interest was not taxed in India. Consequently, the taxpayer was not entitled to the QFIE under Belgian domestic tax law. However, the 1993 treaty between Belgium and India contained a tax sparing provision, pursuant to which Belgian residents were entitled to the QFIE for Indian-sourced income even if that income has not been subject to tax in India[711].

---

[707] Comm. OECD on Art. 24, para. 4, which refers to Comm. OECD on Art. 24, para. 79. The latter paragraph (which concerns Art. 24(5) and will be discussed in detail in 2.F.IV.A), provides that *"since the provisions of paragraph 1 of Article 9 or paragraph 6 of Article 11 form part of the context in which [Art. 24(5)] must be read (as required by Article 31 of the Vienna Convention on the Law of Treaties), adjustments which are compatible with these provisions could not be considered to violate the provisions of [Art. 24(5)]."* See also OECD Public Discussion Draft, 3 May 2007, Application and interpretation of Article 24 (non-discrimination): *"clearly, what is expressly mandated or authorized by other provisions of the Convention cannot constitute a violation of the provisions of Article 24."*

[708] See Art. 31(2) of the Vienna Convention: *"The context for the purpose of the interpretation of a treaty shall comprise, **in addition to the text**, including its preamble and annexes"* (emphasis added).

[709] *T.F.R.* 2007, No. 327, 731. See also L. DE BROE and N. BAMMENS, "Ook tax sparing-credit voor Belgische VI van Indiase vennootschap", *Fisc. Int.* 2007, 288, 4-8.

[710] Art. 285-289 ITC.

[711] See Art. 23(3)(b)(i) and Art. 23(3)(e): *"Where a resident of Belgium derives items of his aggregate income for Belgian tax purposes which are dividends taxable in accordance with paragraph 2 of Article 10, and not exempt from Belgian tax according to sub-paragraph (c), interest taxable in accordance with paragraph 2 or 6 of Article 11, or royalties taxable in accordance with paragraph 2 or 6 of Article 12, the Indian tax levied on that income shall be allowed as a credit against Belgian tax relating to such income in accordance with the existing provisions of Belgian law regarding the deduction from Belgian tax of taxes paid abroad. […] For the purposes of sub-paragraph (b)(i) the term 'Indian tax levied' shall be deemed to include any amount which would have been payable as Indian tax under the laws of India and in accordance with the provisions of the Agreement for any year but for a deduction allowed in computing the taxable income or an exemption from or a reduction of tax granted for that year under: (i) sections 10(4), 10(4B), 10(15)(iv) and 80L of the Income- tax Act, 1961 (43 of 1961), so far as they were in force on, and have not been modified since, the date of the signature of the Agreement, or have been modified only in minor respects so as not to affect their general character; or (ii) any other provision which may be enacted after the Agreement enters into force granting a deduction in computing the taxable income or an exemption from or a reduction of tax and which the competent authorities of the Contracting States agree to be for the purposes of economic development of India, if it has not been modified thereafter or has been modified only in minor respects so as not to affect its general character; the competent authorities may in such a case decide as to the period for which the benefit of this clause shall apply."*

As the taxpayer, an Indian company, was not a Belgian resident, it could not invoke this tax sparing provision. However, the taxpayer argued that its Belgian PE was entitled to the PE on the basis of the PE non-discrimination clause of the Belgian/Indian treaty[712]. The fact that the PE was not entitled to the QFIE amounted to less favourable treatment of the PE as compared to Belgian residents.

Accordingly, the alleged discrimination was not caused by domestic law but by the tax treaty. The provisions of Belgian domestic law that require the income to have been effectively taxed abroad are set aside by the tax sparing credit provided for by Art. 23 of the treaty. And the treaty only grants that credit to Belgian residents. According to the taxpayer, this constituted discrimination of its PE.

The Belgian tax authorities argued that the non-discrimination provision of the treaty could only be applied where the discrimination resulted from domestic law, not where it resulted from tax treaty law. However, the Court dismissed this argument, noting that Art. 24(6) of the treaty defined the term 'taxation' as *"taxes of every kind as specified in this Agreement."* According to Art. 2 of the treaty, this included the Belgian income tax on non-residents. From this, the Court infers that the term 'taxation' used in the non-discrimination provision of the treaty could not be restricted to Belgian domestic taxes. Instead, regard should be had to the whole of the applicable rules, including rules laid down in tax treaties[713].

According to the Court, Art. 24 of the treaty is a rule that applies generally and that completes or corrects other treaty provisions where needed, for instance where they lead to the less favourable treatment of a PE as compared to a resident[714].

The tax authorities had also argued that the situation of the non-resident taxpayer could not be compared to that of a resident taxpayer. The Court dismisses this argument as well, pointing out that it was not the situation of the taxpayer, but the situation of its PE that has to be comparable to that of a Belgian resident. In this respect, the Court sees no reason why the situation of the PE differs from that of a resident carrying on the same activities, except for its status as a PE. The mere fact that the tax sparing clause was intended to stimulate investments in India, in order to support the economy of that country, was not sufficient to conclude that the situation of the PE could not be compared to that of a resident, particularly from the perspective of the non-discrimination provision of the treaty which does not contain any reservation to that effect[715].

---

[712] Art. 24(2) of the treaty, which deviates somewhat from Art. 24(3) OECD MC: *"Subject to the provisions of paragraph 3 of Article 7, the taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities in the same circumstances or under the same conditions."* These differences did not affect the outcome of the judgment. As will be pointed out below, however, Peeters has suggested that these differences may very well affect the correct interpretation of the issue.

[713] *"Suivant l'article 24 § 6 de la CPDI, le terme 'imposition' désigne, au sens de cette disposition, "les impôts de toute nature visés dans la présente convention", soit, en l'occurrence, l'INR-société (voir l'art. 2). De ce libellé, il ne peut être déduit, comme le fait le défendeur, que le mot 'imposition' se limite strictement au droit interne: il vise l'INR-société, établi conformément à l'ensemble des règles fiscales, notamment celles relatives au droit fiscal international belge, dont la CPDI fait partie intégrante."*

[714] *"Cet article 24 […] est une règle qui […] s'applique de façon générale et qui, au besoin, vient compléter ou corriger les autres dispositions de la convention au cas où celles-ci aboutiraient, par exemple, à traiter un établissement stable de manière moins favorable qu'une entreprise résidente."*

[715] *"Ce n'est toutefois pas la situation de la demanderesse, mais la situation de son établissement stable qui est imposé en Belgique qui doit être comparable. A cet égard, le tribunal n'aperçoit pas en quoi la situation de*

The Court therefore concluded that the refusal of the QFIE constituted discrimination of the PE as compared to resident taxpayers.

It is interesting to compare this judgment with the decisions discussed earlier, in 2.B.VI.D.b (Dutch Supreme Court 14 June 1972) and 2.D.III.C.e.1 (*Metchem Canada*). As in the present case, the discrimination in those cases resulted from the provisions of a tax treaty rather than from provisions of domestic law. However, unlike the 1972 case, the taxpayer in the present case does not invoke the non-discrimination provision of a tax treaty in order to claim benefits under another tax treaty. The 1972 case was an actual triangular case, involving three countries and the interplay of two different tax treaties. From the perspective of non-discrimination, triangular cases involve a taxpayer who invokes the non-discrimination provision of one tax treaty in order to claim the benefits of another tax treaty. Given the relative effect of tax treaties, and the reciprocal nature of the benefits granted therein, such a claim should be dismissed.

That was not the case here. As in the *Metchem Canada*-case, there were only two countries involved and the issue revolved around the interplay of different provisions of the tax treaty between those two countries[716]. In *Metchem Canada*, it was clear that the Contracting States wanted to deviate from the non-discrimination provision in the treaty by expressly confirming a discriminatory provision of domestic law. Here, the discrimination results from Art. 23 of the treaty, which restricts the benefit of the tax sparing clause to Belgian residents. The purpose of the tax sparing clause is to support the development of the Indian economy by stimulating Belgian residents to invest in India[717]. More specifically, Indian domestic law provided for a number of tax incentives in order to stimulate economic growth, i.e. the return on certain investments was free from tax. The tax sparing credit is designed to respect the source State's taxing rights (i.e. India can tax the income but chooses not to do so), while at the same time preventing that the incentive effect of the source State's domestic measures would be negated by taxation of the relevant income in the investor's State of residence (Belgium)[718]. From that perspective, it seems unlikely that the Contracting States intended to deviate from the PE non-discrimination clause. Rather, the restriction of the tax sparing benefit to Belgian residents can be explained by the fact that Art. 23(3) of the Belgian/Indian treaty prescribes how Belgium should avoid double taxation where its residents derive income

l'établissement stable de la demanderesse diffère de celle des entreprises résidentes belges qui exercent une activité identique, si ce n'est sa qualité d'établissement stable. La seule circonstance que le but d'une clause de 'tax sparing' soit de créer un incitant fiscal afin de favoriser les investissements dans des Etats dont l'économie a besoin d'être assistée ne peut suffire à constater que la situation de l'établissement stable n'est pas comparable à celle d'une entreprise résidente, en particulier à la lumière du principe de non-discrimination expressément prévu dans la CPDI, lequel ne comporte aucune réserve à ce sujet."

[716] The problem at issue in the present case, where a resident of State A receives income that is sourced in State A through its PE in State B, has been referred to as a 'biltaral triangular case' (M. GUSMEROLI, "Triangular cases and the Interest and Royalties Directive: untying the Gordian Knot? – Part 1", *European Taxation* 2005, 7). I will reserve the term 'triangular cases' for situations involving three States (and, hence, two treaties). In my opinion, the problem at issue here was not triangular in nature, but concerned a conflict between two different provisions of a tax treaty.

[717] For a general overview, see OECD, *Tax Sparing. A reconsideration*, Paris, 1998. See also M. MEIRELLES, "Tax sparing credits in tax treaties: the future and the effect on EC law", *European Taxation* 2009, 263-273, who argues that EU Member States should not include tax sparing credits in their tax treaties because they are ineffective and incompatible with EU law.

[718] See Art. 23(3)(e)(ii) of the treaty: the tax sparing clause also applied to income that was taxable in India under the treaty, but was exempt there by reason of *"any other provision […] granting a deduction in computing the taxable income or an exemption from or a reduction of tax* ***and which the competent authorities of the Contracting States agree to be for the purposes of economic development of India****"* (emphasis added).

that falls under the treaty. Consequently, the PE non-discrimination clause requires Belgium to extend the tax sparing credit to the PE of an Indian resident.

That being said, there is an additional issue in the case at hand. As mentioned, the QFIE was granted to Belgian residents by virtue of Art. 23(3)(e), which provided that, for purposes of Art. 23(3)(b)(i), *"the term 'Indian tax levied' shall be deemed to include any amount which would have been payable as Indian tax under the laws of India* ***and in accordance with the provisions of the Agreement*** *for any year but for a deduction allowed in computing the taxable income or an exemption from or a reduction of tax granted for that year […]"* (emphasis added). Yet in the case at hand, the interest payment was made by an Indian resident to the Belgian PE of another Indian resident. Art. 11 of the treaty does not apply to such a payment, since the interest is not 'paid to' a resident of the other Contracting State[719].

This situation is referred to in the Commentary on Art. 21, which confirms that Art. 21(2)[720] also applies where the beneficiary and the payer of the income are both residents of the same Contracting State and the income is attributed to a PE which the beneficiary has in the other Contracting State. In such a case, the PE State has the right to tax the income under Art. 7. If double taxation arises, the residence State should give relief under Art. 23. However, the Commentary notes that a problem may arise as regards the taxation of dividends and interest in the residence State, which is also the source State: because Art. 7 applies, the source State cannot levy source tax on the income. In contrast, if the income had been paid to a resident of the other Contracting State, the source State would have been able to levy source tax (at the rates provided for in Art. 10(2) or 11(2)[721].

The same problem arises in the present case. As Article 7 applies to the interest, India could not levy source tax under the treaty, with the result that Belgium did not have the obligation to provide for relief from double taxation through the tax sparing credit. If the interest had been paid to a Belgian resident, India could apply source taxation under Art. 11(2) and Belgium would be required to grant relief (even if no actual Indian tax was levied). Consequently, if we assume that Art. 24(3) of a tax treaty can be invoked by a PE to claim relief granted to residents in another provision of the same treaty (see supra), then the case at issue is a prime example of that situation: a Belgian resident company that receives interest from India would be entitled to the credit under Art. 23 of the treaty, while the Belgian PE of an Indian taxpayer is not entitled to that credit. Art. 24(3) could remedy this discrimination[722].

---

[719] Art. 11(1): *"Interest arising in a Contracting State and* ***paid to a resident of the other Contracting*** *State may be taxed in that other State"* (emphasis added).

[720] Which contains the following exception to the general rule of Art. 21 that 'other income' is exclusively taxable in the recipient's State of residence: *"The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein and the right or property in respect of which the income is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply."*

[721] Comm. OECD on Art. 21, para. 5, reference to which is made in Comm. OECD on Art. 24, para. 72. The Commentary proposes that Contracting States resolve this issue bilaterally by including a provision in the treaty that allows the taxpayer's State of residence, as the source State of the income, to levy a source tax at the rates provided for in Art. 10(2) or 11(2). The PE State would then grant a credit for the tax so levied (except, of course, where the PE State does not tax the dividends or interest in accordance with its domestic law).

[722] It has been suggested, however, that the present case is different because of the wording of the PE non-discrimination clause in the applicable tax treaty between Belgium and India. The comparison above was made between the Belgian PE and a Belgian resident company which is entitled to the credit upon receipt of Indian-sourced interest. However, the object of comparison in the PE non-discrimination clause of the Belgian/Indian treaty is an enterprise of the PE State *"carrying on the same activities in the same circumstances or under the*

III.D. No extension to personal allowances

The second sentence of Art. 24(3) states that the PE non-discrimination clause does not require the PE State to extend to PEs of non-residents *"any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents."* As noted in 1.C.IV, this sentence was added in the OEEC Working Party's third report and has been included in the PE non-discrimination clause ever since. The Working Party was quite brief on the reasons for the inclusion and only noted that 'certain delegations' considered it necessary to include a reservation in the PE non-discrimination clause so as to *"relieve a State in whose territory a permanent establishment is situated when such an establishment is owned by an individual or by a partnership of individuals, of the obligation to extend to the owner or owners of the establishment who reside outside its territory, the tax reliefs which it grants its own residents on account of their civil status and family responsibilities"*[723]. In the context of Art. 24(3), this reservation seems redundant, since only 'enterprises' are entitled to protection under the provision (see 2.D.I) and since it only applies to the taxation of the PE itself (see 2.D.III.A).

According to the Commentary, this sentence specifies the conditions under which the clause should be applied to individuals with a PE in the other Contracting State: it is intended to ensure that such persons do not obtain greater advantages than residents of the PE State, through entitlement to personal allowances and reliefs for family responsibilities, both in their State of residence (under its domestic law), and in the PE State (under Art. 24(3))[724]. Consequently, the PE State can choose whether or not to give personal allowances and reliefs to such persons in proportion to the amount of income the PE's profits represent in the worldwide income taxable in the State of residence[725].

---

same conditions." For this reason, it has been suggested that the comparison should instead be made with a Belgian company that is **not** entitled to a credit because India does not have the authority to levy source tax under the treaty. The underlying reasoning is that the PE non-discrimination clause requires the object of comparison to be "in the same circumstances", which would include the circumstance that India is unable to levy tax under the treaty. Since, in that case, the object of comparison would not be entitled to the QFIE either, no discrimination arises. Obviously, that reasoning cannot be transposed to treaties following the OECD MC, given the absence of a "same circumstances" requirement (B. PEETERS, "On anti-discrimination provisions and permanent establishments in bilateral triangular situations", in L. HINNEKENS and P. HINNEKENS, *A vision of taxes within and outside European borders. Festschrift in honor of Prof. Dr. Frans Vanistendael*, 2008, Kluwer Law International, Alphen aan den Rijn, 676-677). Given the rarity of treaties with a same circumstances-requirement in the PE non-discrimination clause, the importance of this discussion should not be overstated (to my knowledge, the treaties with India and Kuwait are the only Belgian treaties where this requirement is included; on the other hand, a significant number of treaties concluded by India include such a requirement). Nevertheless, it seems unlikely that the inability for India to levy source tax under the treaty where a PE is involved should be taken into account in the comparison. The reason why India cannot levy source tax is that Article 7 allocates the exclusive taxing right to Belgium. Consequently, if this element were taken into account in the 'same circumstances' test, then PEs would, by definition, never be comparable to residents as regards relief for foreign tax. Such an interpretation would significantly reduce the effectiveness of the provision.

[723] FC/WP4 (57)4, 3.

[724] It is clear from the wording of the Commentary that this sentence only applies to individuals. In German case law, however, it has been decided that Art. 24(3), as a general rule, only applies to business-related taxation criteria, not to 'person-related taxation criteria' (e.g. the obligation to disclose hidden reserves upon the transfer of business assets from a PE to a resident company in return for shares was considered to be a consequence of the change in personal ownership of the business assets, with the result that Art. 24(3) did not apply). See the critical discussion of this case law in K. VOGEL, *o.c.*, 1317-1318.

[725] Comm. OECD on Art. 24, para. 36.

Some treaties deviate from the OECD MC and provide expressly that personal tax exemptions and deductions awarded by a Contracting State are also awarded to taxpayers resident in the other Contracting State. Such benefits are then not only granted to residents of one Contracting State with a PE in the other Contracting State, but to all residents of the former Contracting State. Consequently, this is not merely a deviation from the restriction imposed by the second sentence of Art. 24(3) OECD MC, but an additional non-discrimination clause intended to protect residents of the other Contracting States.

Even though such clauses are only rarely included in treaties, there is some interesting case law on their interpretation. For example, such a clause was included in Art. 25(3) of the 1970 treaty between Belgium and the Netherlands[726]: *"Individuals who are residents of one of the States shall benefit in the other State from the same personal allowances, reliefs and deductions on account of civil status or family responsibilities which the last-mentioned State grants to its own residents."*[727].

There has been some disagreement on the question as to which benefits fall within the scope of the phrase *"personal allowances, reliefs and deductions on account of civil status or family responsibilities"*. The Belgian tax authorities traditionally took the position that the scope of the clause was limited to the tax-free threshold and the allocation of a portion of a taxpayer's

[726] In the 2001 treaty, this provision has been replaced by Art. 26(2): *"Individuals who are residents of a Contracting State and who derive from the other State gains or income for which the right to tax has been allocated to that other State in accordance with the provisions of Chapter III of this Convention, are entitled, at the time of taxation in said latter State, insofar as these gains or income are included in their worldwide income, to the same personal allowances, reliefs and reductions on account of civil status or family responsibilities as are residents of that other State, insofar as they are in the same circumstances as the residents of that State."* Accordingly, the allowances are granted on a pro rata basis, in proportion to the amount of income derived in the source State. For an example where the 2001 provision was applied, see Antwerp 2 February 2010, No. 2008/AR/3170, discussed hereafter.

[727] Similarly, e.g., Art. 25(2) of the 1975 treaty between the Netherlands and Suriname. See also Art. 24(4) of the 1968 treaty between Belgium and Greece: *"Individuals resident in a Contracting State who are taxable in the other State shall be entitled in the last-mentioned State – for purposes of the base of the taxes calculated, in accordance with the law of that other State, at progressive rates or on a base reduced by reliefs – to exemptions, reliefs from the base, deductions or other advantages which are granted on account of family charges to individuals who are nationals of and resident in that other State"* and Art. 21(3) of the 1972 treaty between Belgium and Morocco: *"Individuals resident in one of the Contracting States who are taxable in the other State shall, for the purposes of determining the base for taxes calculated in accordance with the law of that other State at progressive rates or on a base reduced by certain amounts, benefit there from the exemptions, deductions, reductions and other allowances, which are granted on account of civil status to individuals who are nationals of that other State and resident there."* Both the treaty with Greece and the treaty with Morocco have been replaced by new a treaty (of 2004 and 2006, respectively), neither of which includes a provision extending these benefits to residents of the other Contracting State. For a peculiar incarnation of such a provision, see Art. 25(2) of the 1964 Belgian/French treaty: *"Notwithstanding the provisions of paragraph 1, individuals who are residents of a Contracting State and who exercise salaried employment in the other Contracting State shall not be subjected in that other State, in respect of income from such activity, to any taxation or requirement connected therewith which is more burdensome than the taxation and connected requirements to which individuals who are residents of that other State and who exercise salaried employment are or may be subjected. Personal deductions, allowances and reductions of tax, on account of civil status or family responsibilities granted by the other State to its own residents shall be granted to the persons mentioned in the preceding sentence, but shall be reduced by the ratio of the remuneration arising in that other State to the total professional income, wherever arising, of which the persons are the beneficiaries."* A judgment involving the latter provision is discussed in L. DE BROE and N. BAMMENS, "Eloi v Belgium. Deductibility of alimony in Belgium contrary to the free movement of workers. Tribunal de Première Instance de Bruxelles", *Highlights & Insights on European Taxation* 2009, 1, 65-70.

earned income to his spouse in case the latter has very little or no earned income[728]. However, this strict interpretation has been dismissed in case law. For instance, it has been decided that this clause entitles non-residents to the same conditions with respect to the deductibility of maintenance payments as residents. Under Belgian domestic tax law, it was impossible for non-residents to deduct maintenance payments made to other non-residents, while no such restriction applied for maintenance payments made by residents to non-residents. The Ghent Court of Appeal held that this distinction violated Art. 25(3) of the Belgian/Dutch treaty[729]. Afterwards, the Belgian tax authorities have taken a less strict approach[730].

Hereafter, a number of cases will be discussed in order to illustrate the difficulties in interpreting this clause.

a. Dutch Supreme Court 19 December 1990[731]

According to the Dutch Supreme Court, the rule of Art. 25(3) of the 1970 Belgian/Dutch treaty applies even where it results in a situation where the residents of the other Contracting State are better off than the State's own residents.

The taxpayer was a 65 year old individual who lived in Belgium with his spouse. The matrimonial property included immovable property of f 255,000 situated in the Netherlands. Under domestic tax law in the Netherlands, immovable property situated in the Netherlands was taxable for residents and non-residents alike. However, residents were treated more favourably than non-residents in respect of the applicable tax-free threshold. For resident taxpayers, the tax-free threshold for unmarried taxpayers was either f 56,000 or f 88,000 (depending on whether they were younger or older than 27), while it was f 112,000 for married taxpayers. Moreover, the income of a married resident was taxed in the hands of the spouse if his employment income was lower than that of the spouse. In contrast, the income of married non-residents was not taxed jointly. As a result, married non-residents who jointly owned immovable property in the Netherlands were each taxed separately on half of the value of the property. In the present case, the taxpayer was thus taxable in the Netherlands on an amount of f 127,500. As regards the tax-free threshold, the non-resident was granted half of the threshold to which a married resident would be entitled, i.e. a threshold of f 56,000 (because the immovable property was divided in half between them for tax purposes, each of the spouses was entitled to half of the tax-free threshold to which residents would be (jointly) entitled).

The question arose whether (and to what extent) the taxpayer was entitled to a tax-free threshold in the Netherlands under Art. 25(3). The taxpayer argued that he should be entitled to a threshold of f 112,000. However, the Court of Appeal decided that the taxpayer was entitled to a threshold of f 88,000, i.e. the threshold granted to a resident unmarried taxpayer of the same age as the taxpayer in casu. The tax authorities appealed against this decision, arguing that the Court of Appeal's approach would entail that married non-residents were treated more favourably than married residents: both married non-residents would be entitled

[728] I.e. the so-called *'huwelijksquotiënt'* or *'quotient conjugal'*. See the Official Commentary on the Income Tax Code, No. 243/30.
[729] Ghent Court of Appeal 27 June 1996, *Fisc. Koer.* 1996, 470. See also the decision of the Dutch Supreme Court 6 November 1996, No. 30.245, *BNB* 1997/300, discussed hereafter and L. DE BROE and N. BAMMENS, "Eloi v Belgium. Deductibility of alimony in Belgium contrary to the free movement of workers. Tribunal de Première Instance de Bruxelles", *Highlights & Insights on European Taxation* 2009, 1, 65-70.
[730] See infra, on the Administrative Circular of 26 October 2000.
[731] Hoge Raad 19 December 1990, No. 27.064, *BNB* 1991/123.

to a threshold of f 88,000 in the Netherlands (totalling f 176,000), while married residents were only entitled to a (joint) threshold of f 112,000.

The Supreme Court dismissed the tax authorities' claim. The Supreme Court first notes that the tax-free threshold falls within the scope of the person and family related benefits referred to in Art. 25(3) of the treaty. The Court dismisses the argument that, in order to avoid married non-residents from being treated more favourably than married residents, the threshold of f 112,000 should be split between both the non-resident taxpayer and his spouse. According to the Court, Art. 25(3) requires that the Netherlands grant to non-residents the tax-free threshold that it grants to all married residents, regardless of whether their assets and liabilities are taxed in their hands or in the hands of their spouse[732]. Therefore, the Court of Appeal was incorrect in deciding that the taxpayer was entitled to a threshold of f 88,000. Instead, the taxpayer was entitled to a threshold of f 112,000[733].

b. Dutch Supreme Court 11 September 1991[734]

The same Court decided that Art. 25(3) of the 1970 Belgian/Dutch treaty does not apply to the deduction of losses incurred by the non-resident taxpayer's spouse. The taxpayer was an individual who lived in Belgium with his spouse. The taxpayer and his spouse jointly owned immovable property in the Netherlands, in respect of which they incurred a loss in the assessment year at issue. Unlike his spouse, the taxpayer earned employment income in the Netherlands. In declaring this employment income in the Netherlands, the taxpayer deducted the full amount of the loss incurred in respect of the immovable property.

If a married resident jointly owned immovable property with his spouse and his spouse did not earn any employment income in the Netherlands, he could deduct the full amount of the loss incurred in respect of the immovable property because of the joint assessment in such a case (see supra). In contrast, married non-residents were taxed separately, with the result that they could only deduct half the amount of the loss in such a case. As the spouse had no employment income in the Netherlands, the other half of the loss could not be deducted. Consequently, the tax administration only allowed the taxpayer to deduct half of the loss. The taxpayer argued that he should be able to deduct the full amount on the basis of Art. 25(3) of the treaty.

The Supreme Court dismissed this argument[735]. According to the Court, the possibility for a resident taxpayer to deduct the full amount of the loss in such a case was not a "personal

[732] *"De onderwerpelijke verdragsbepaling brengt mee dat aan belanghebbende de belastingvrije som toekomt die de wet toekent aan alle gehuwde binnenlandse belastingplichtigen, ongeacht of hun bezittingen en schulden bij hen zelf in de vermogensbelasting worden betrokken dan wel worden toegerekend aan hun echtgenoot."*
[733] Strictly speaking, this seems to go beyond the obligation imposed by Art. 25(3) of the treaty, which required **the same** benefits to be granted to non-residents (implying that it would have been sufficient to grant half of the threshold of f 112,000, as that was the threshold to which a married resident would have been entitled). However, non-residents were not assessed jointly in the Netherlands. As a result, the tax treatment of the taxpayer in the present case had to be considered in isolation from the benefits granted to his spouse (i.e. the possibility that his spouse would also be entitled to a tax-free threshold in the Netherlands). The effect of the joint assessment on the object of comparison (a married resident) had to be left out of the analysis when determining the benefit to which the non-resident was entitled.
[734] Hoge Raad 11 September 1991, No. 27.585, *BNB* 1991/318.
[735] *"De […] toerekening van inkomensbestanddelen tussen echtgenoten strekt immers niet – gelijk in artikel 25, lid 3 van het Verdrag is vereist – tot het verlenen van een persoonlijke aftrek, tegemoetkoming of vermindering uit hoofde van burgerlijke staat of samenstelling van het gezin. Dit blijkt ook uit de omstandigheid dat deze toerekening niet alleen negatieve maar ook positieve inkomensbestanddelen kan betreffen."* The Advocate-

allowance, relief or deduction on account of civil status or family responsibilities" within the meaning of Art. 25(3). This deduction was not determined by the taxpayer's personal or family circumstances, but by fact that the immovable property gave rise to a loss in the year at issue. According to the Court, this conclusion was further supported by the fact that the allocation of income to the spouse of a resident taxpayer could not only concern losses but also positive income[736].

c. Dutch Supreme Court 6 November 1996[737]

The taxpayer was a Belgian resident. He was separated from his spouse, who lived in the Netherlands with their three children. In the assessment year at issue, the taxpayer made maintenance payments to his spouse, his children and his mother. He also incurred medical expenses, both for himself and for his spouse and children. In declaring his employment income earned in the Netherlands, the taxpayer sought to deduct all these expenses. However, the Dutch tax authorities only allowed the deduction of the maintenance payments to his children. The taxpayer lodged appeal, arguing that Art. 25(3) of the treaty required the deductibility of all these expenses.

The Supreme Court first notes that the expression *"personal allowances, reliefs and deductions on account of civil status or family responsibilities"* is not defined in the treaty or annexed documents. Moreover, Art. 3(2) of the treaty did not offer a solution since the expression was not used in Dutch domestic law either.

In looking for supplementary means of interpretation[738], the Court then notes that the expression is also used in Art. 24 OECD MC. However, the expression serves an entirely different purpose in that context: it is intended to clarify that the PE non-discrimination clause does not mean that non-residents are entitled to personal benefits. The interpretation given to the expression in the context of the OECD MC is therefore not relevant, as Art. 25(3) of the Belgian/Dutch treaty concerns the opposite situation, i.e. it concerns the question which benefits **should** be extended to non-residents[739].

General had reached the same conclusion: *"Naar mijn oordeel kan de verrekening van negatieve inkomsten met positieve inkomsten uit anderen hoofde niet aangemerkt worden als een tegemoetkoming, een vermindering of een persoonlijke aftrek […] uit hoofde van de gezinssamenstelling of de gezinslasten van de belastingplichtige. Daaraan doet niet af, dat het in het onderhavige geval gaat om de verrekening van de helft van de negatieve inkomsten uit onroerend goed die, zo de belanghebbende en zijn echtgenote in Nederland hadden gewoond, wel verrekend zouden zijn en, nu zij in België wonen, niet verrekend worden. Deze aftrekpost wordt naar zijn aard niet bepaald door de persoon of het gezin van de belastingplichtige, maar door de, aan het onroerend goed verbonden, omstandgheid dat het in een jaar verlies oplevert."*

[736] Arguably, the disadvantage at issue was not due to the nature of the loss at issue, but due to the restriction of the joint assessment to residents. As this joint assessment included income from immovable property (both positive and negative), non-residents who jointly owned immovable property in the Netherlands were unable to benefit from this regime. It could be argued that such a regime has more to do with the taxpayer's personal and family circumstances (and, particularly, his being married) than the Court is willing to accept. Compare this for instance to the decision of the ECJ in *Schumacker*, discussed in Part III, 2.E.I.A.b.1.a.1: the German splitting regime – pursuant to which the spouses' total income was aggregated, notionally attributed to each spouse as to 50% and then taxed accordingly – was held to constitute a 'person-related benefit'. However, as will be pointed out below, the Dutch Supreme Court interprets the expression *"personal allowances, reliefs and deductions on account of civil status or family responsibilities"* narrowly, excluding benefits that do not relate to obligations arising directly from family law.

[737] Hoge Raad 6 November 1996, No. 30.245, *BNB* 1997/300.

[738] See Art. 32 Vienna Convention.

[739] *"Deze tekst heeft de strekking duidelijk te maken dat de gelijke behandeling van de vaste inrichting niet mag dienen als argument om een verplichting aanwezig te achten buitenlanders ook maar enige persoonlijke aftrek*

The Court finally refers to Art. 24(1) of the 1959 treaty between Germany and the Netherlands, which provides as follows: *"The nationals of one of the States shall not be subjected in the other State to any taxation which is other or higher than the taxation to which the nationals of that other State in similar circumstances are subjected. The same provision shall apply as regards the extent of **any tax allowances, reliefs and reductions granted on the basis of marital status or family circumstances**"* (emphasis added). The Court considers this to be a supplementary means of interpretation and holds that *"personal allowances, reliefs and deductions on account of civil status or family responsibilities"* should be defined as *"all allowances, reliefs and deductions relating to the fact that the taxpayer has obligations and liabilities arising directly from family law"*[740].

As a result, the Court only allowed the deduction of maintenance payments made to the taxpayer's spouse and children – including payments relating to their medical expenses – and to his mother. The taxpayer's own medical expenses could not be deducted.

The approach taken by the Supreme Court is in line with earlier remarks made by Kemmeren, who argued that the term 'personal' in Art. 25(3) has no separate meaning, and that the provision is only concerned with benefits relating to the taxpayer's marital status or household composition. Accordingly, maintenance payments to former spouses, foster children, relatives, persons related by marriage, etc. fall under the scope of this definition. However, benefits relating to the taxpayer's personal situation, which have no causal link with his marital status or household composition, fall outside its scope. For instance, the deductibility of personal medical expenses only relates to the taxpayer himself and has no bearing on his marital status or household composition[741].

The Supreme Court confirmed this interpretation in 2010[742]. At issue was a tax credit in Dutch domestic tax law that was granted to residents having reached 65 years of age, whose income did not exceed a certain limit (*'ouderenkorting'*) and an increase in the tax-free threshold that was granted on similar conditions (*'ouderentoeslag'*). The taxpayer, a Belgian resident, argued that she was entitled to these benefits on the basis of Art. 25(3) of the 1970 treaty. The Supreme Court dismissed this argument, pointing out that the benefits did not

als in die tekst aangeduid te verlenen. Zodanige bepaling kan bezwaarlijk licht werpen op een bepaling als artikel 25, paragraaf 3, van de Overeenkomst waarin het juist gaat om de vraag welke persoonlijke aftrek wel behoort te worden verleend. […] Aan artikel 24, lid 4, tweede volzin, van het modelverdrag [komt] hier [dan ook] geen betekenis toe." That argument is not very convincing. It may be true that both provisions serve a different purpose, in that one seeks to exclude non-residents from certain benefits while the other extends those benefits to non-residents. But that does not change the fact that both provisions concern the **same benefits**. Consequently, the interpretation of Art. 24(3) OECD MC can very well be relevant for the interpretation of Art. 25(3) of the Belgian/Dutch treaty: understanding which benefits are excluded by the former provision implies understanding which benefits are extended by the latter provision.

[740] *"Alle aftrekken, tegemoetkomingen en verminderingen die verband houden met de omstandigheid dat de belastingplichtige rechtstreeks uit het familierecht voortvloeiende verplichtingen en lasten heeft."* The importance which the Court attaches to the 1959 treaty with Germany is curious, given the earlier statement that the interpretation of Art. 24(3) OECD MC was irrelevant. The expression used in the treaty with Germany serves a different purpose (it prohibits discrimination on the basis of nationality, rather than residence) and the wording is different from that in the treaty with Belgium (i.e. no reference to 'personal' allowances).

[741] E. KEMMEREN, "Persoonlijke verminderingen op grond van non-discriminatie in belastingverdragen", *WFR* 1993, 6044, 227. *Contra*: A. DANIELS, "Hoge Raad 6 November 1996, No. 30.245 – Case note", *BNB* 1997/300, who argues that the term 'personal' should be given its normal meaning, with the result that 'personal allowances' are all allowances that relate to the taxpayers personal circumstances (which, presumably, includes the deductibility of medical costs and other benefits that have no bearing on the taxpayer's marital status).

[742] Hoge Raad 19 February 2010, No. 08/02184.

concern obligations and liabilities arising directly from family law. Rather, these benefits were granted because the taxpayer had reached retirement age. As a result, Art. 25(3) was not applicable[743].

d. Antwerp Court of Appeal 2 February 2010[744]

1. The Court's decision

As a final example, consider this decision of the Antwerp Court of Appeal, which illustrates the interplay between the tax treaty provision on personal allowances and the ECJ's case law on that issue.

The taxpayers were a married couple who were both residents of Belgium. The man derived employment income exclusively from Belgium, while his spouse derived employment income exclusively from the Netherlands. They opted for joint taxation in Belgium. In their Belgian tax return, they claimed a deduction for childcare and for household services[745].

Art. 23(1)(a) of the 2001 Belgian/Dutch treaty and Art. 155 of the Belgian Income Tax Code provide that Belgium applies the exemption-with-progression method to avoid double taxation with respect to foreign employment income. Applying these provisions, the Belgian tax authorities allocated the deductions proportionally to the employment income derived from Belgium and the Netherlands[746]. The taxpayer argued that this proportional allocation violated the free movement of workers.

The Court of Appeal first referred to the ECJ's decision in *De Groot*, in which it was held that, in principle, the residence State must grant all allowances which take into account the

---

[743] See also the Decree of the Dutch Finance Minister of 20 April 2010 (Besluit No. DGB2010/568M, *Nederlandse Staatscourant* 27 April 2010, No. 6364), which was issued as a response to the Hoge Raad judgment of 19 February 2010. The Decree lists a number of domestic allowances that are not *"personal allowances … on account of civil status or family responsibilities"* within the meaning of Art. 26(2) of the 2001 Belgian/Dutch treaty (which replaces Art. 25(3) of the 1970 treaty) because there is no causal link with the taxpayer's marital status or household composition. For instance, the *'arbeidskorting'* (a credit granted to all persons with earned income), the *'doorwerkbonus'* (a credit for persons aged 62 and older who are still employed) and the *'korting voor directe beleggingen in durfkapitaal en culturele beleggingen'* (a credit for venture capital investments and cultural investments) are not *"personal allowances … on account of civil status or family responsibilities"* for that reason. However, some of these allowances, including the *arbeidskorting* and the *doorwerkbonus*, are available to Belgian residents on the basis of the free movement of workers (see Hof 's-Hertogenbosch 21 December 2006, No. 04/02152, LJN: BA1390).

[744] Antwerp 2 February 2010, No. 2008/AR/3170. The decision can be found on 'Fisconetplus', the online database of the Belgian tax authorities (www.fisconet.be).

[745] These deductions are provided for in Articles 113 and 145/21 ITC, respectively.

[746] Article 155 ITC provides that income that is exempt in Belgium pursuant to a tax treaty is taken into account for calculating the amount of tax due, but that tax is reduced proportionally to the ratio between the exempt income and the aggregate income. The Belgian tax authorities traditionally apply that provision as follows: the reduction granted for foreign income = (amount of tax due on the aggregate income after application of the tax-free threshold and other tax reductions) x [(net foreign income, after a proportional deduction of professional expenses and other allowances) / (net aggregate income, after deducting professional expenses and other allowances)]. As a result, a taxpayer earning part of his income abroad loses a portion of the allowances. Moreover, this calculation also results in a partial loss of tax reductions (i.e. amounts to be deducted from the tax due as such), such as the tax reduction for long-term savings, because these are deducted from the amount of tax due on the aggregate income. Given the similarity of this formula to the one at issue in *De Groot*, it seems difficult to reconcile with EU law (see also S. VAN BREEDAM, "Is berekeningsmethode van progressievoorbehoud strijdig met Europees recht?", *T.F.R.* 2005, No. 282, 503-506). As will be pointed out hereafter, the Belgian tax authorities have tried to remedy this issue by publishing a Circular in 2008, which provides for an additional tax reduction.

personal and family situation of the taxpayer, because his centre of personal and capital interest is located in that State. However, this is different when the taxpayer derives his income mainly in the State of employment. In that case, the personal and family allowances must be granted by the State of employment because the taxpayer derives insufficient income in his residence State to claim the benefits there[747].

The Court of Appeal noted that the spouse was in the latter situation since all of her employment income was derived from the Netherlands. Accordingly, it was up to the Netherlands to grant the personal and family allowances.

Moreover, the Court observed that the spouse's employment income was exclusively taxable in the Netherlands under Art. 15 of the treaty and that Art. 26(2) of the treaty required the Netherlands to grant her the same personal and family allowances as to which residents of the Netherlands were entitled, insofar as she was in the same circumstances as residents of the Netherlands[748]. According to the Court of Appeal, this tax treaty requirement for the Netherlands to grant the personal and family allowances was in accordance with ECJ's decision in *De Groot*, where the ECJ held that the Member States are free, in the absence of unifying or harmonising measures, to alter, by way of a tax treaty, the correlation between the taxpayer's total income and the obligation to take account of his personal and family circumstances (for instance by partially releasing the State of residence from this obligation as regards residents who derive part of their employment income abroad). Moreover, the State of residence could also be released from that obligation if it finds that the work State grants such advantages to non-resident taxpayers who receive taxable income there, with respect to the income taxed by the work State[749].

The taxpayers argued that, despite the obligation imposed on the Netherlands under Art. 26(2) of the treaty, they were not entitled to any allowance with regard to childcare or household services in the Netherlands. However, the Court of Appeal held that this was the result of a difference in the tax legislation in Belgium and the Netherlands which, in itself, could not be deemed discriminatory. As noted earlier, there can only be discrimination if the disadvantage incurred by a taxpayer results from the legislation of one State, and not if that disadvantage is due to the interplay of the legal systems of different States. As a result, the pro rata allocation of the deductions by the Belgian tax authorities could not be said to violate the free movement of workers.

2. Administrative Circular

As a side-note, it should be pointed out that, in a Reasoned Opinion of 20 July 2006, the European Commission requested Belgium to amend the legislation at issue here. According to the Commission, the limited deduction of personal and family allowances for residents with both Belgian and foreign income is contrary to the fundamental freedoms[750]. Because

---

[747] See, in general, the discussion of the *Schumacker*-doctrine in Part III, 2.E.I.A.b.1.a and, in particular, the discussion of *De Groot* in Part III, 2.E.I.A.b.1.a.6.

[748] As pointed out earlier, Art. 26(2) of the 2001 treaty provides: *"Individuals who are residents of a Contracting State and who derive from the other State gains or income for which the right to tax has been allocated to that other State in accordance with the provisions of Chapter III of this Convention, are entitled, at the time of taxation in said latter State, insofar as these gains or income are included in their worldwide income, to the same personal allowances, reliefs and reductions on account of civil status or family responsibilities as are residents of that other State, insofar as they are in the same circumstances as the residents of that State."*

[749] C-385/00, *De Groot*, § 99-100.

[750] See the Press Release of 20 July 2006, IP/06/1048.

Belgium did not amend its legislation, the Commission referred Belgium to the European Court of Justice in 2007[751]. However, that procedure was closed after the Belgian tax authorities published an administrative Circular in 2008 in order to bring the Belgian regime in line with *De Groot*[752].

The Circular provides for an additional tax reduction in Belgium for situations where a resident loses part of his personal or family allowances because he derives income from another Member State, which does not take account of the personal and family circumstances. The reduction equals the positive difference between (a) the amount of Belgian tax due (calculated using the method of exemption with progression), increased with the tax levied in the other State relating to the income earned in that State and (b) the tax which would have been due if the income was derived exclusively from sources in Belgium and all the relevant taxes were payable in Belgium[753].

According to the Circular, the 'personal and family allowances' include in particular the following allowances: allowances relating to a handicap of the taxpayer, to the taxpayer's children or other persons in the taxpayer's care, to the handicap of the taxpayer's children or other persons in the taxpayer's care, to child care costs, to maintenance payments (and similar payments) and to the taxpayer's spouse who earns no income. The following allowances are **not** included: allowances relating to income (e.g. the lump-sum deduction of professional expenses), to investments which are not related to the taxpayer's personal or family circumstances (e.g. tax benefits related to a loan contracted for building or renovating a house), to the recruiting of domestic workers and to gifts made to charitable causes.

The basic conditions for the application of the additional reduction are[754]:
(1) The taxpayer has derived income from one or more EER Member States and that income is exempt in Belgium by virtue of a tax treaty;
(2) In the calculation of the taxes due in those States on the income that is exempt in Belgium, those States have not granted the personal or family allowances to which the taxpayer would have been entitled if he was a resident of those States;
(3) The taxpayer is not fully entitled in Belgium to the allowances relating to his personal and family circumstances.

---

[751] See the Press Release of 8 January 2007, IP/07/13.
[752] Circ. nr. Ci.RH.331/575.420 (AOIF 8/2008) of 12 March 2008.
[753] Consequently, if the latter amount (the amount of tax which would have been due if the income was sourced exclusively in Belgium) is higher than the overall amount of tax due (i.e. the amount of Belgian tax due + the amount of foreign tax due on the exempt income), then the taxpayer is not entitled to the additional reduction. This will be the case, for instance, where the tax rates in the source State are lower than the tax rates in Belgium. This approach does not seem to be contrary to the ECJ's position in *De Groot*, since there is no discrimination if the allowance is equal to the amount which the taxpayer could have claimed if he had derived his total income in the State of residence (see C-385/00, *De Groot*, § 113-115; see also T. JANSEN, "Bijkomende belastingvermindering voor buitenlandse inkomsten. Velen zijn geroepen, weinigen uitverkoren", *Fisc. Act.* 2008, 16, 4). Nevertheless, it has been argued that the Circular is insufficient to remove the violation of the fundamental freedoms because it does not cover all the tax advantages connected with the non-resident's ability to pay tax, which the ECJ seems to require in *Lakebrink* (e.g. S. VAN BREEDAM, "Implementatie arrest De Groot: Circulaire gaat niet ver genoeg", *Fiscoloog* 2008, 1113, 9).
[754] If a joint assessment is applied, the conditions are applied for both spouses together. If not, it would be possible for a taxpayer to obtain the additional reduction while his spouse has already received the allowances abroad. This specification does not seem to violate EU law, as the ECJ has decided in *Gschwind* that it is not problematic to take the family income into consideration, and not just the income of the spouse working in another Member State (see Part III, 2.E.1.A.b.1.a.5).

However, if the applicable tax treaty provides that the personal and family allowances are granted by the source State on a pro rata basis (e.g. the treaties with the Netherlands and France), then the additional reduction does not apply. Accordingly, the taxpayer in the case before the Antwerp Court of Appeal was not entitled to the additional restriction because the applicable tax treaty provided that the Netherlands would grant a pro rata portion of the allowances to which residents of the Netherlands were entitled.

A number of additional conditions apply[755]. For instance, the taxpayer is not entitled to the additional reduction in Belgium if the source State does not provide for the allowance in question (e.g. the source State does not grant allowances for child care costs, while Belgium does)[756] or if the income earned abroad has not been effectively subject to a tax that is similar to the Belgian individual income tax.

e. Conclusion

The main problem in applying a treaty provision concerning *"personal allowances, reliefs and deductions on account of civil status or family responsibilities"* is that this expression is generally not defined in the treaty. From the wording of the expression, it seems clear that only benefits granted on account of the taxpayer's marital status or family responsibilities qualify (*"personal allowances […]* ***on account of*** *civil status or family responsibilities"*). In that respect, the observation made by Kemmeren, that 'personal' has no separate meaning, should be recalled: all benefits granted on account of the taxpayer's marital status or family responsibilities are, by definition, 'personal'. As a result, benefits that are granted for strictly personal reasons of the taxpayer, independently from marital status or family responsibilities (e.g. personal medical costs) fall outside the scope of the provision.

However, the Belgian tax administration seems to take a less strict position: in the 2008 Circular, discussed above, it is pointed out that 'tax allowances relating to the taxpayer's handicap' are included in the definition. Thus, it seems that the Belgian tax authorities, unlike Kemmeren, consider that the term 'personal' does have a separate meaning. However, it is unclear which allowances are covered by this term since the Circular does not contain an exhaustive list of benefits that qualify as personal and family allowances. Moreover, it should be stressed that the 2008 Circular of the Belgian tax authorities was published in response to the ECJ's decision in *De Groot*. Indeed, the *De Groot* case law concerns *"allowances relating to a taxpayer's personal and family circumstances"*, which is less restrictive than *"personal allowances […] on account of civil status or family responsibilities"*. From that perspective, it is unlikely that the 2008 Circular is suitable for the interpretation of the non-discrimination provision in the Belgian/Dutch treaty.

On the other hand, Art. 25(2) of the 1964 treaty between Belgium and France also grants a proportional part of the *"personal deductions, allowances and reductions of tax, on account of civil status or family responsibilities"* to residents of the other contracting State. In 2000,

---

[755] For a general overview of the conditions set out in the Circular, see T. JANSEN, "Bijkomende belastingvermindering voor buitenlandse inkomsten. Velen zijn geroepen, weinigen uitverkoren", *Fisc. Act.* 2008, 16, 1-5.

[756] In fact, this is what the decision of the Antwerp Court of Appeal comes down to: the mere fact that the work State (the Netherlands) does not grant an allowance to its residents in a situation where Belgium would do so, does not mean that there is discrimination. Indeed, the taxpayer is not discriminated against as compared to residents of the work State. The fact that Belgium grants allowances in situations where the Netherlands does not, is not a matter of discrimination but merely of disparities in legislation.

the Belgian tax administration has addressed the interpretation of that phrase in a Circular[757]. The Circular points out, for instance, that the deductibility of maintenance payments is covered by the clause (see supra, on the decision of the Ghent Court of Appeal). Moreover, the Circular also includes the inreased tax-free threshold for handicapped taxpayers in the definition. Once again, this seems to imply that the Belgian tax authorities give the term 'personal' a separate meaning, and that other benefits than those on account of civil status or family responsibilities may also be covered[758].

That being said, the question remains what is meant by benefits *"on account of civil status or family responsibilities"*. Surely, 'on account of' refers to a causal link between the benefit and the civil status or family responsibilities. As 'civil status' and 'family responsibilities' are not defined in the treaty, these expressions should be interpreted under the domestic law of the State applying the treaty[759]. If there is no specific definition in tax law, the general domestic (family) law definition applies. If no domestic definition can be found, the ordinary meaning of the expression should be used[760].

Consequently, when domestic tax law attaches a tax benefit to these factors, the conditions have been met. From this perspective, one may wonder whether the joint assessment at issue in the 1991 case could also be seen as a benefit on account of civil status: if a resident taxpayer is married, domestic tax law grants him the benefit of the joint assessment regime. The Dutch Supreme Court decided that this did not come within the scope of the relevant provision because it was not related to an obligation arising directly from family law.

However, that interpretation is too narrow. As regards the interpretation of 'family responsibilities', it is likely that domestic family law attaches a number of obligations and responsibilities to marriage, blood relationships, adoptive relationships, etc. If domestic tax law grants certain benefits by reason of these responsibilities, there is little doubt that these benefits *"relate to the fact that the taxpayer has obligations and liabilities arising directly from family law"*. However, the provision also refers to benefits on account of civil status. 'Civil status' does not refer to a specific responsibility imposed by domestic law. Rather, it concerns the fact that an individual falls within the scope of a definition given in domestic law, e.g. whether that individual is married. When domestic tax law attaches a benefit to this circumstance, this cannot be defined as a benefit *"relating to the fact that the taxpayer has obligations and liabilities arising directly from family law"*. Where domestic tax law grants a benefit to a resident because of his marital status, the provision applies as well. Apparently, the definition given by the Dutch Supreme Court overlooks this aspect.

Take, for instance, the joint assessment regime at issue in the 1991 case. It cannot be denied that this benefit was granted to residents "on account of civil status": the benefit was granted because the taxpayer was married. If the taxpayer in that case had been a resident, he would have been able to deduct the full amount of the loss, because of the joint assessment applicable to married taxpayers. I see no reason why such benefits should be excluded from provisions such as Art. 25(3) of the 1970 Belgian/Dutch treaty.

[757] Circular No. AFZ/INTERN.IB/96.0470 of 26 October 2000, *Bull. Bel.* 2000, No. 810, 3260, as amended by the.
[758] Apparently, the definition also covers tax reductions for long-term savings; see the Circular of 6 May 2002 amending Circular No. AFZ/INTERN.IB/96.0470, *Bull. Bel.* 2002, No. 828, 1805.
[759] Art. 3(2) OECD MC.
[760] Art. 31 Vienna Convention.

As a final point, it should be noted that the tax treaty provision on personal allowances and the *De Groot* case law provide for different obligations. The tax treaty provision requires the work State to grant non-residents the same personal allowances as it grants to its residents (generally limited on a pro rata basis). In contrast, *De Groot* addresses both the work State and the residence State. The basic obligation is imposed on the residence State: it is generally up to that State to take account of a taxpayer's personal and family circumstances, since that is generally where his personal and financial interests are centred. However, that obligation shifts to the work State in situations where the taxpayer derives (almost) all of his employment income in that State and where he has no significant income in his State of residence. Yet, that basic position, which is in line with *Schumacker*, may be altered in a tax treaty between the Member States involved. In particular, the tax treaty may provide that the work State grants a proportional share of personal allowances to non-residents deriving employment income in that State, with the result that the residence State is partially released from its basic obligation to fully take account of the taxpayer's personal and family circumstances. Moreover, the residence State may also be released from that obligation where the work State, even in the absence of a tax treaty, grants those allowances to the taxpayer in question.

Consequently, while the tax treaty provision seeks to eliminate discrimination between residents and non-residents, the obligation under the fundamental freedoms is mainly concerned with ensuring that no discrimination occurs between taxpayers earning part of their income in another Member State and taxpayers earning all of their income in their State of residence. It is up to the Member States themselves to decide how this result should be reached: either by implementing the *Schumacker*-doctrine (i.e. fully granting personal allowances to residents working abroad unless their home State income is insignificant, and, conversely, fully granting those benefits to non-residents who earn most of their income there), or by proportionally dividing the obligation to grant the allowances between home State and work State (whether it be in a tax treaty, or in domestic law by only granting allowances to the extent the other State has not done so)[761].

E. Article 24(4): deductibility

I. General

Art. 24(4) OECD MC prohibits discrimination as regards certain payments, such as interest and royalties, made by enterprises[762] of a contracting State to a resident of the other contracting State. States may want to disallow the deduction of such payments because they believe that their domestic tax base could be eroded if residents are able to shift income abroad through payments to a (related) non-resident.

Unlike the other paragraphs of Article 24, this provision was not included in the 1963 OECD Draft Convention. The 1963 Commentary on Art. 11 and 12, however, pointed out that certain countries do not allow interest or royalties paid to be deducted for the purposes of the payer's tax unless the recipient also resides in the same State or is taxable in that State. The Fiscal Committee considered it *"desirable that the deduction in question should also be allowed in*

[761] See, in particular, C-385/00, *De Groot*, § 101.
[762] On the interpretation of the term 'enterprise', see 2.D.I.

cases where the interest or royalties are paid by a resident of a Contracting State to a resident of the other State, the case of fraud being, of course, reserved"[763].

Since the 1977 Model, this recommendation has been incorporated as a separate paragraph in Art. 24 OECD MC. The Model makes no reference to fraud in this context, but the Commentary on Art. 24(4) provides that it is open to contracting States *"to modify this provision in bilateral conventions to avoid its use for tax avoidance purposes"*[764]. The Commentary on Art. 11 and 12 has also been amended to provide that *"the question whether the deduction should also be allowed in cases where the [interest or royalties] are paid by a resident of a Contracting State to a resident of the other State, is dealt with in paragraph 4 of Article 24"*[765].

The rule laid down in Art. 24(4) is that interest, royalties and other disbursements paid by a resident of a contracting State to a resident of the other contracting State must, for the purpose of determining the taxable profits of the business carried on by the payer, be deductible under the same conditions as if they had been paid to a resident of the payer's State. The same applies to debts of a resident of a contracting State to a resident of the other contracting State as regards the determination of the debtor's taxable capital. For this reason, Art. 24(4) is generally referred to as the deductibility non-discrimination provision.

Art. 24(4) applies to interest[766], royalties[767] and other disbursements. The expression 'other disbursements' should be interpreted broadly, as referring to all payments in the nature of a consideration for goods or services received (e.g. rental payments)[768]. Strictly speaking, it could be argued that the 'other disbursements' (*'autres dépenses'* in French) are confined to monetary payments[769]. Consequently, payments in kind, i.e. payments with a medium other than legal tender, would not fall under Art. 24(4). Both the English and the French text use the verb 'paid' (*'payé'*), which might support this argument. However, this is an overly narrow interpretation which unduly restricts the scope of the non-discrimination provision. From a substantive point of view, there is no reason why payments in kind should be treated differently from other payments for the purpose of discrimination. In any event, the scope of the provision is limited to payments for consideration: gifts, etc. are excluded[770].

> The expression 'other disbursements' also includes contributions to pension schemes. Consequently, an employer making such contributions on behalf of his employees to a non-

[763] Comm. OECD 1963 on Art. 11, para. 17 and on Art. 12, para. 9.
[764] Without express reference to fraud. On the impact of Art. 24(4) on domestic anti-abuse measures, see infra.
[765] Comm. OECD on Art. 11, para. 4 and on Art. 12, para. 2.
[766] Which is defined in Art. 11(3) as *"income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest"*.
[767] Which are defined in Art. 12(2) as *"payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience."*
[768] K. VOGEL, *o.c.*, 1326.
[769] The Technical Explanation to the 2006 U.S. Model Convention, for instance, observes that the term 'other disbursements' is *"understood to include a reasonable allocation of executive and general administrative expenses, research and development expenses and other expenses incurred for the benefit of a group of related persons that includes the person incurring the expense."*
[770] See K. VOGEL and M. LEHNER, *Doppelbesteuerungsabkommen*, Verlag C.H. Beck, München, 2008, 5 Auflage, 1734.

resident pension scheme can invoke that provision if the conditions for deductibility differ as compared to contributions made to resident schemes. But since Art. 24(4) only concerns the deductibility for purposes of determining taxable profits, an employee's contributions to a pension fund are not covered. As a result, an employee making such contributions to a scheme established in another State cannot rely on Art. 24(4) to claim non-discriminatory treatment as regards deductibility in his home State. In order to address this issue (and a number of related issues occurring in the context of cross-border employment), the OECD Commentary on Art. 18 contains the following optional clause on cross-border pension contributions: *"contributions to a pension scheme established in and recognised for tax purposes in a Contracting State that are made by or on behalf of an individual who renders services in the other Contracting State shall, for the purposes of determining the individual's tax payable and the profits of an enterprise which may be taxed in that State, be treated in that State in the same way and subject to the same conditions and limitations as contributions made to a pension scheme that is recognised for tax purposes in that State"*[771].

This clause seeks to ensure equal treatment as regards the tax treatment of cross-border pension contributions, both from the perspective of the worker and that of the employer. The scope of the provision is quite broad. It covers all three pension pillars (i.e. social security schemes, occupational pension schemes and individual retirement schemes) and since it uses the word 'individual', it covers not only employees but also self-employed workers. Additionally, it is not required that the worker becomes resident in the host State: it is only required that he renders services there[772]. Furthermore, by using the expression 'by or on behalf of', the provision applies to contributions made directly by the worker, but also to contributions made for the worker's benefit by the employer or another party (e.g. a spouse)[773]. Finally, the most important difference from Art. 24(4) is that the proposed clause covers not only the deductibility of the contributions but the entire tax treatment thereof. For instance, Art. 24(4) would be to no avail where the employer's contributions to a non-resident scheme are treated as a taxable benefit in the hands of the employee. If that is not the case for contributions to a resident scheme, the proposed clause would offer a solution[774].

II. The comparability-test

a. No express comparability requirement

The subject of comparison is a resident of contracting State A who pays interest, royalties or other disbursements to a resident of contracting State B. The object of comparison is a resident of contracting State A who makes such payments to a resident of contracting State A. Accordingly, the protection offered by Art. 24(4) is protection against discrimination **by the taxpayer's home State** (unlike Arts. 24(1) and (3)), i.e. the State of residence of the person paying the disbursement or owing the debt (see supra, on the definition of the term 'an

---

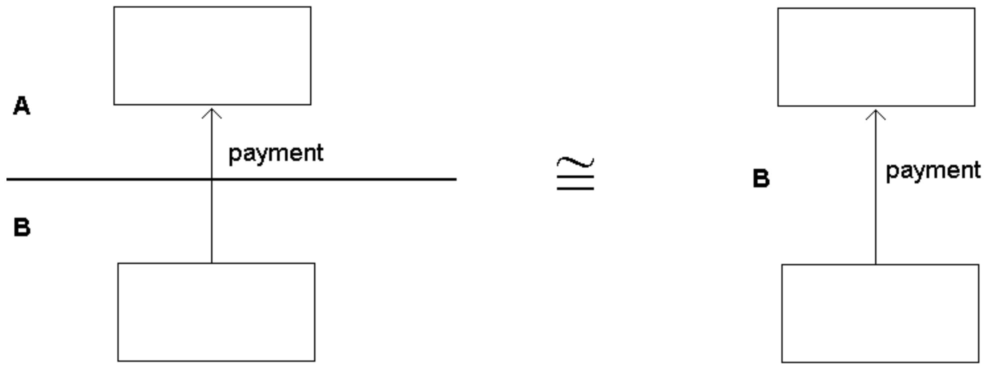
[771] Comm. OECD on Art. 18, para. 37. Two conditions apply: the individual was not a resident of the host State, and was participating in the pension scheme, immediately before beginning to provide services in that State, and the pension scheme must be accepted by the competent authority of the host State as generally corresponding to a pension scheme recognised as such for tax purposes by that State. As a result of the latter condition, tax relief cannot be claimed, for instance, when the worker moves from an EET State to a TEE (or TTE) State (L. DE BROE and R. NEYT, "Tax treatment of cross-border pensions under the OECD Model and EU law", *Bull. IBFD* 2009, 87).

[772] Comm. OECD on Art. 18, para. 44. Of course, in order to be entitled to treaty protection, the worker must be a resident of either the host State or the State where the pension scheme is established (Comm. OECD on Art. 18, para. 46).

[773] Comm. OECD on Art. 18, para. 49.

[774] Comm. OECD on Art. 18, para. 49.

enterprise of a contracting State')[775]. Schematically, the comparison can be represented as follows:



Unfortunately, the provision offers little guidance as to the proper construction of the comparison. It is particularly remarkable that Art. 24(4) does not include a reference to 'the same circumstances' (as in Arts. 24(1) and (2)), 'carrying on the same activities' (as in Art. 24(3)) or 'similar enterprises' (as in Art. 24(5)). This omission seems to imply that Art. 24(4) has a broader scope than the other clauses of Art. 24 OECD MC.

Consider, for instance, a domestic thin cap rule in State A that applies exclusively to payments made by residents to tax-exempt entities, including non-residents that are not subject to taxation in that State but also resident entities that are tax-exempt for specific reasons such as charitable organizations. The subject of comparison is a State A resident making a payment to a non-resident, but what is the appropriate object of comparison in such a case? A resident making a payment to **an exempt resident** or a resident making a payment to **a non-exempt resident**?

If Art. 24(4) were to include a same circumstances requirement, the only possible comparison would be with a resident making a payment to an exempt resident. Clearly, the fact that the subject of comparison makes a payment to a recipient who is not subject to tax in State A (i.e. a non-resident) is a relevant characteristic from the perspective of State A's thin cap rule. That characteristic is not inherently linked with the comparative attribute (the recipient's residence) since there are also resident recipients who are exempt. Accordingly, the object of comparison is a resident enterprise making a payment to an **exempt** resident. Since the object of comparison is not entitled to the deduction either, there is no discrimination.

[775] Obviously, Art. 24(1) cannot be relied on to challenge such measures by the home State. For instance, a taxpayer who pays interest to a related foreign company and who is unable to deduct these payments because of thin cap rules introduced by his home State cannot argue that Art. 24(1) is violated because (payments to) foreign companies are treated less favourably than (payments to) domestic companies. In such cases, the discrimination is between different types of residents depending on where the recipient of their payments is established, not between nationals and foreigners or residents and non-residents. See, e.g., the decision of the French Conseil d'Etat in *SAS France*, 16 February 1990, *RJF* 4/90 No. 393, concerning the 1936 treaty between France and Sweden, which included a nationality non-discrimination provision in Point XIV of the Protocol, but no provision corresponding to Arts. 24(4) or 24(5) OECD MC. The taxpayer relied on this nationality non-discrimination provision to challenge the French thin cap rules, which denied deductibility of interest payments to non-residents in certain situations. The Court correctly dismissed this claim, because that provision only offers protection from discrimination on the basis of nationality. Here, the distinction was not made on the basis of the French taxpayer's nationality, but on the basis of the recipient's place of residence. See also G. BLANLUET, "Thin capitalization and non-discrimination", *European Taxation* 1991, 56-59. Similarly, Cour Administrative d'Appel Nancy 10 October 2002, N° 98NC01741, LexisNexis.

However, the text of Art. 24(4) does not contain any reference to a same circumstances-test. For that reason, it could be argued that there is nothing to preclude a comparison between a payment made to a non-resident recipient and a payment made to a **non-exempt** resident recipient. Since Art. 24(4) does not require the subject and object of comparison to be in the same circumstances, it could be argued that there is discrimination because the former is not entitled to a deduction while the latter is.

Phrased differently, the analysis under Art. 24(4) raises the question *"if the payment had been made to a resident, would it have been deductible?"* The answer to that question in the present case is that in some cases, it would have been deductible while in other cases it would not. As a result, there is an argument that a domestic thin cap rule that targets all tax-exempt entities nevertheless falls foul of Art. 24(4). In contrast, if Art. 24(4) included a same circumstances-test, the question would be *"if the payment had been made to a resident in the same circumstances, would it have been deductible?"* In that case, the answer would certainly be in the negative, with the result that there is no discrimination. More specifically, if the payment is made to a resident who is in the same circumstances as regards being tax-exempt in the payer's State, it would not be deductible either. Given the express inclusion of a similar test in all the other clauses of Art. 24 OECD MC, it seems that the omission of a same circumstances-test in Art. 24(4) is intentional. As demonstrated here, this may give rise to some unfortunate results.

Arguably, that interpretation is too broad from the perspective of the purpose and objective of Art. 24(4) but it nevertheless seems to be in line with the text of the provision[776]. It would therefore be preferable to include a same circumstances test in the text of Art. 24(4).

As an example, consider the U.S. 'earnings stripping rule' of s. 163(j) IRC, which was adopted in 1989 and which, under certain circumstances (e.g. when a fixed debt/equity ratio is exceeded), denies an interest deduction to U.S. corporations for interest payments to related, 'tax-exempt' parties[777]. The measure is not restricted to payments made to non-residents, but it applies to all 'tax exempt related parties', i.e. to domestic tax exempts as well as foreigners. As a result, the measure does not exclusively target foreign taxpayers but applies to all recipients, domestic or not, that are not subject to U.S. income taxation.

The U.S. takes the approach that this rule does not constitute an infringment of the non-discrimination provision in tax treaties. For instance, the House Committee Report on the introduction of this rules states: *"cases involving domestic tax-exempt entities should receive similar treatment to cases involving foreign tax-exempt persons. For example, if two unrelated U.S. charities each own half of a U.S. corporation, its interest payments to them are not includible in the charities' income. Therefore, the ability to strip earnings is present. The committee believes it is appropriate to limit the ability of domestic tax-exempt entities to strip earnings in such a manner. […] The committee understands that the impact of this limitation may fall heavily on foreign-based multinational corporations. However, the*

[776] The Commentary is not conclusive either. The only possible reference to this issue is the statement that Art. 24(4) *"is designed to end a particular form of discrimination resulting from the fact that in certain countries the deduction of interest, royalties and other disbursements allowed without restriction when the recipient is resident, **is restricted or even prohibited when he is a non-resident**"* Comm. OECD on Art. 24, para. 73 (emphasis added). That statement could be read as implying that Art. 24(4) only prohibits rules that specifically target payments made to non-residents, but it seems too general in nature to outwheigh the clear omission of a same circumstances test in the text of the provision itself.

[777] For the purpose of this analysis, I presume that the conditions under which the deduction is denied are not in line with Art. 9(1). If these conditions comply with Art. 9(1), there is no need to verify whether the domestic measure is in accordance with Art. 24(4) OECD: see 2.E.IV.

provision generally applies across the board to all tax-exempt U.S. persons and tax-exempt foreigners. The committee does not believe that the impact of this limitation on foreign-owned entities violates any treaty nondiscrimination provision"[778].

While this interpretation squares with the spirit of Art. 24(4), it may be difficult to reconcile with the text of that provision. As pointed out earlier, Art. 24(4) does not contain a same circumstances-test with the result that non-resident recipients could be considered comparable to non-exempt resident recipients for the purposes of Art. 24(4)[779].

On the other hand, it could also be argued that the reference to residence in Art. 24(4) OECD MC (i.e. the subject of comparison being a resident that makes a payment to a **non-resident**) is really a reference to the recipient's scope of tax liability in the source State. Assuming that a resident is generally subject to unlimited tax liability while a non-resident is generally subject to limited tax liability, it could be argued that a non-resident recipient is by definition incomparable to a non-exempt resident recipient, given the different scopes of tax liability[780].

In this context, it is appropriate to refer to the ECJ's judgment in *Lankhorst-Hohorst*[781], which dealt with German thin cap rules. Under those rules, interest payments were recharacterized as dividends if a fixed debt/equity ratio was exceeded and if the interest was paid to a substantial shareholder 'not entitled to corporation tax credit'. There was no entitlement to 'corporation tax credit' for, firstly, non-resident corporations and, secondly, German corporations that were exempt from corporation tax, namely legal persons governed by public law and those carrying on business in a specific field or performing tasks which should be encouraged. In other words, the thin cap rule did not distinguish on the basis of residence, but on the basis of being tax-exempt in Germany. This is the situation discussed above: instead of distinguishing between residents and non-residents, the thin cap rule distinguishes between persons who are subject to tax and persons who are tax-exempt. Before the ECJ, the German tax authorities argued that there was no discrimination contrary to the fundamental freedoms because the domestic measure also targeted several categories of German taxpayers.

The ECJ dismissed that argument. The Court pointed out that, in the large majority of cases, resident parent companies received a tax credit, whereas, as a general rule, non-resident parent companies did not. German corporations who were not entitled to the credit were

---

[778] H.R. Rep. No. 247, 101st Cong., 1st Sess. 1989, 1242 and 1249 (*WL* 168143).

[779] See also R. DOERNBERG, "Overriding tax treaties: the U.S. perspective", *Emory International Law Review* 1995, 98-100.

[780] Of course, this argument can also be used the other way around. In particular, since non-residents are by definition subject to limited tax liability while residents are subject to unlimited liability, the reference in Art. 24 to the recipient's place of residence implies that it does not offer protection from discrimination on the basis of location but on the basis of the scope of tax liability. Under that interpretation, Art. 24(4) thus precludes a contracting State from distinguishing between payments made to persons subject to full tax liability and persons subject to limited or no tax liability (including tax-exempt resident entities). In other words, this interpretation assumes that the application of the domestic rules not only to non-residents but also to resident exempt persons (as was the case for the U.S. measure discussed above), is solely intended to avoid the appearance of a treaty override. With respect to the U.S. earnings stripping rule of s. 163(j) IRC discussed above, see R. AVI-YONAH, "International Tax as International Law", John M. Olin Center for Law & Economics Working Paper Series No. 04-007, 18: *"When the rule was adopted the U.S. was very worried it will appear to be a violation of the non-discrimination provision in tax treaties if it applied only to foreign related parties. Thus, to avoid even the appearance of a treaty override, the U.S. instead applied the rule to all 'tax exempt related parties', i.e., to domestic tax exempts as well as foreigners. But this was an obvious ruse, since no domestic tax exempts are ever related (i.e., control over 50%) to domestic taxable subsidiaries."* However, such an interpretation of Art. 24(4) is quite far-fetched and finds little support in the text of the provision.

[781] C-324/00, *Lankhorst-Hohorst*, 12 December 2002 (see Part III, 2.E.I.A.b.5.c).

essentially legal persons governed by public law and those carrying on business in a specific field or performing tasks which should be encouraged. The situation of a non-resident parent company which is carrying on a business for profit and is subject to corporation tax, *"cannot validly be compared to that of the latter category of corporations"*[782]. In other words, the fact that certain resident taxpayers were also targeted by the domestic rule in question was not sufficient to demonstrate that there was no discrimination. As a resident tax-exempt corporation could not validly be compared to a non-resident taxpayer carrying on a business for profit, such a resident could not be considered in constructing the object of comparison. Accordingly, the object of comparison was restricted to resident taxpayers paying interest to resident shareholders other than resident tax-exempt corporations. Since the subject of comparison (a resident paying interest to a non-resident shareholder carrying on a business for profits) was unable to deduct the interest, while the object of comparison (a resident paying interest to a resident shareholder carrying on a business for profit) was able to do so, the ECJ held that the measure discriminated on the basis of the parent company's seat.

As pointed out above, the text of Art. 24(4) OECD MC may support a similar conclusion. Since that provision does not require the object and subject of comparison to be in the same circumstances, it could be said that a non-resident recipient is comparable to a non-exempt resident recipient, with the result that distinguishing between them as regards deductibility constitutes discrimination. On the other hand, the absence of a same circumstances test also implies that there is nothing to prevent a non-resident recipient from being compared to a tax-exempt resident, with the result that there is no discrimination (since the object of comparison is also unable to deduct the interest). Ultimately, the problem is that Art. 24(4) does not offer any guidance on how to construct the object of comparison, with the result that any comparison is possible.

The situation may be more straightforward where tax-exempt residents lose their tax-exempt status by making a qualifying loan. Suppose, for instance, that a pension fund is tax-exempt, unless it makes a loan that qualifies under the relevant thin cap rules. In that case, the rule exclusively targets non-residents. Even though, from a formal point of view, the rule also covers residents, its practical application is such that it exclusively applies to non-residents. As a result, there is no object of comparison that incurs the same disadvantage as the subject of comparison, that is to say, there cannot be a situation in which the thin cap rule is applied to interest paid to a resident[783]. Consequently, irrespective of the object of comparison that is chosen, the taxpayer has a valid argument for discrimination under Art. 24(4) in such a case[784].

> A different position is taken by VAN RAAD, who argues that an explicit same circumstances-test is redundant because identity in circumstances is inherent in the concept of non-discrimination. Consequently, a domestic rule which denies deductibility of interest paid to non-residents and to tax-exempt residents does not infringe Art. 24(4)[785]. Because that provision contains an implicit same circumstances-test, a resident making a payment to

[782] C-324/00, *Lankhorst-Hohorst*, § 28.

[783] Additionally, in drafting a such a thin cap rule, a contracting State is arguably not performing its treaty obligations in good faith (Art. 26 Vienna Convention). By drafting a rule that formally does not discriminate against non-residents but, by its practical application, only targets non-residents, it could be said that the State in question is not acting in good faith.

[784] See also J. AVERY JONES and C. BOBBETT, "Interpretation of the non-discrimination Article of the OECD Model", *B.I.F.D.* 2008, 51.

[785] K. VAN RAAD, *o.c.*, 176.

> a non-resident should be compared to a resident making a payment to an exempt resident. Since the latter is not entitled to a deduction either, there is no discrimination.
>
> However, I find no support for this position in the OECD MC or in the Commentary. In my opinion, the only indication to that effect is Comm. OECD on Art. 24, para. 3, which states: *"The various provisions of Article 24 prevent differences in tax treatment that are solely based on certain specific grounds (e.g. nationality, in the case of paragraph 1). Thus,* ***for these paragraphs to apply, other relevant aspects must be the same****. The various provisions of Article 24 use different wording to achieve that result (e.g. 'in the same circumstances' in paragraphs 1 and 2; 'carrying on the same activities' in paragraph 3; 'similar enterprises' in paragraph 5)"* (emphasis added). While this statement refers in general terms to 'the various provisions of Article 24', it is striking that it only makes an express reference to paras. 1, 2, 3 and 5, without saying anything about Art. 24(4).
>
> If a same circumstances-test is indeed inherent in the discrimination-analysis of Article 24, it would be preferable to either remove the reference to this test in paras. 1, 2, 3 and 5, or to include an express statement to that effect in Art. 24(4) (e.g. *"[…] interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall […] be deductible under the same conditions as if they had been paid to a* ***similar*** *resident of the first-mentioned State."* In the absence of such an amendment, interpreting Art. 24(4) as including an implicit same circumstances-test would be subject to debate, if not incorrect.

b. 'Under the same conditions' as a comparability requirement?

Alternatively, it could be argued that the expression 'under the same circumstances' functions as a comparability requirement of sorts. To take the example given above, it could be said that there is no discrimination because payments made to residents and payments made to non-residents are deductible **under the same conditions**. That is to say, neither the former nor the latter are deductible if they are made to an exempt entity. The conditions for deductibility (i.e. that the recipient is a non-exempt entity) are thus identical for payments made to residents and payments made to non-residents. As a result, there is no discrimination contrary to Art. 24(4).

To some extent, this interpretation removes the tension between the text of Art. 24(4) and its purpose (see supra). But the problem is that the expression 'under the same conditions' is not concerned with the relevance of characteristics. As noted earlier, comparability requires that all relevant characteristics are identical. Take, for instance, Art. 24(5), which states that the object of comparison is a 'similar' domestically-owned enterprise. The term 'similar' requires that all relevant characteristics, apart from foreign ownership, are identical between the subject of comparison (a foreign-owned enterprise) and the object of comparison (a domestically-owned enterprise) (see infra).

To take the example given above, consider that a domestic rule grants a tax benefit to all resident enterprises, except for resident enterprises owned by tax-exempt entities. Presumably, the tax-exempt status of the shareholder is a relevant characteristic. Furthermore, being tax-exempt is not inextricably linked with the comparative attribute (the shareholder's non-residence) since there are also resident tax-exempt entities (e.g. charities). As a result, a resident enterprise owned by a non-resident is not comparable to a resident enterprise owned by a non-exempt resident, with the result that the domestic measure (which grants a tax benefit exclusively to the latter) does not constitute discrimination contrary to Art. 24(5). On the other hand, a resident enterprise owned by a non-resident is comparable to a resident enterprise owned by an exempt resident, but since neither is entitled to the tax benefit, there is no discrimination.

Now assume that Art. 24(5) did not include the term ‘similar’, but only required that foreign-owned enterprises are not subject to other taxation than domestically-owned enterprises. Art. 24(5) would then be similar to Art. 24(4), since neither expressly requires comparability. Accordingly, the same problem would arise, namely that the text of Art. 24(5) would not offer any guidance on the construction of the object of comparison. As a result, it is possible to make the comparison both with a resident enterprise owned by a non-exempt resident (in which case there is discrimination) and with a resident enterprise owned by an exempt resident (in which case there is no discrimination). On the other hand, it could also be said that the prohibition of ‘other’ taxation functions as a comparability requirement of sorts. More specifically, it could be said that foreign-owned enterprises are not subject to ‘other’ taxation as compared to domestically-owned enterprises, since both categories are only entitled to the tax benefit if they are not owned by a tax-exempt entity[786].

In other words, the result would be the same, irrespective of whether an express comparability requirement is included in the text of the provision. So from that perspective, Art. 24(4) is not different from the other provisions of Art. 24 OECD MC. As noted above, however, the problem is that comparability implies a test of relevance. To illustrate this, consider a domestic measure that only grants tax benefits to resident enterprises on the condition that they are owned by companies that are listed on the national stock exchange. Furthermore, assume that, in order to be listed, a company must be resident and that being listed is irrelevant for the tax benefit at issue. Since the requirement in Art. 24(5) that the subject and object of comparison must be ‘similar’ implies that all relevant characteristics should be identical, the characteristic of being listed should be left out of the comparability-analysis (see 2.F.II.C). As a result, a resident enterprise owned by a non-resident is comparable to a resident enterprise owned by a resident listed enterprise (assuming that all other relevant characteristics are identical), which means that there is discrimination contrary to Art. 24(5).

But if Art. 24(5) would not include the reference to similarity, the conclusion is different. Indeed, it is clear that foreign-owned enterprises are not subject to ‘other’ taxation as compared to domestically owned enterprises: both categories are only entitled to the tax benefit if they are owned by a company that is listed on the national stock exchange. Since there is no ‘other’ taxation, it cannot be said that the domestic measure gives rise to discrimination contrary to Art. 24(5).

The same is true for Art. 24(4) OECD MC. The absence of a comparability requirement means that the relevance of characteristics is not considered. As soon as payments made to

---

[786] Similarly, the expression “not other or more burdensome” in Art. 24(1) could also be interpreted as requiring comparability. Assume that State A’s legislation grants a tax benefit exclusively to residents. Since Art. 24(1) requires the circimstances to be the same, in particular with respect to residence, a non-national non-resident cannot be compared to a national resident. The only appropriate comparison is with a national non-resident, which means that there is no discrimination since neither the subject nor the object of comparison is entitled to the tax benefit. Now assume that Art. 24(1) did not require the circumstances to be the same. It could then be argued that State A’s legislation is still not contrary to Art. 24(1) since non-nationals are not subject to ‘other or more burdensome taxation’ than nationals: the benefit is only granted if the taxpayer is a resident. Since the taxation is not ‘other’ for non-nationals than for nationals, there is no discrimination. So either the express comparability-test in paragraphs (1), (2) and (5) is redundant, in which case it would be better to remove it altogether, or it is not redundant, in which case its absence in Art. 24(4) means that the comparability-test under that paragraph is different.

non-residents are subject to the same conditions as regards deductibility, the domestic regime is compatible with Art. 24(4).

III. The disadvantage test

Art. 24(4) requires the relevant payments (or debts) **to be deductible under the same conditions** as if they had been paid (or contracted) to a resident of the payer's (or debtor's) contracting State. Therefore, the obligation imposed by this provision does not call for a comparison of the tax burden on the subject of comparison to that imposed on the object of comparison (unlike Arts. 24(1), (2), (3) and (5) OECD MC). Instead, the conditions under which the relevant payments (or debts) are deductible for the purpose of determining the taxpayer's taxable base (or capital) must be the same. That is to say, the prerequisites for deductibility must be the same for subject and object of comparison[787].

As an example of such different conditions, reference can be made to timing differences as regards deductibility. Where a domestic rule provides that payments made to non-resident recipients are deductible only when they are paid (cash basis) while payments made to resident recipients are deductible when accrued (accrual basis), it is clear that the conditions for deductibility are not the same[788]. For that reason, a taxpayer could invoke Art. 24(4) in order to obtain a deduction on an accrual basis for payments made to non-residents. This is also confirmed in the 2008 Discussion Draft on Art. 24[789].

Since the 2008 update, the Commentary also notes that Art. 24(4) does not prohibit additional information requirements with respect to payments made to non-residents *"since these requirements are intended to ensure similar levels of compliance and verification in the case of payments to residents and non-residents"*[790]. This exception is difficult to reconcile with

[787] Since neither the OECD MC, nor the Commentary qualify the type of 'conditions' with which Article 24(4) is concerned, it seems that the provisions targets both substantive and procedural rules on deductibility. Accordingly, any type of measure which distinguishes between payments made to residents and payments made to non-residents as regards deductibility may conflict with Article 24(4).

[788] See also the *Square D*-case, discussed in 2.F.II.D.g, where a similar issue is considered from the perspective of Art. 24(5) OECD MC.

[789] OECD, "Application and interpretation of Article 24 (non-discrimination). Public discussion draft", 3 May 2007, 27, para. 75: *"As regards the deferral of deductions, the Working Group agreed that different rules as to when expenses may be deducted may be in violation of paragraph 4 (subject to the other requirements of that paragraph."* The Czech tax authorities have also acknowledged that such a timing difference constitutes a violation of Art. 24(4); see J. ZOUBEK, "Czech Republic", in IFA, *Cahiers de droit fiscal international. Non-discrimination at the crossroads of international taxation*, Vol. 93a, Amersfoort, Sdu Fiscale & Financiële Uitgevers, 2008, 228-229. In contrast, the Argentine tax authorities have argued that such a distinction does not infringe Art. 24(4) because that provision only refers to interest, royalties, etc. that has been **paid** to a non-resident. For that reason, it would not be discriminatory to allow the deduction only after the payment has actually been made to the non-resident. Clearly, that argument is not very convincing (see C. ROSSO ALBA, "Argentina", in IFA, *Cahiers de droit fiscal international. Non-discrimination at the crossroads of international taxation*, Vol. 93a, Amersfoort, Sdu Fiscale & Financiële Uitgevers, 2008, 102).

[790] See Comm. OECD on Art. 24, para. 75. A similar statement is included in the Commentary with respect to Art. 24(5) (Comm. OECD on Art. 24, para. 80; see 2.F.III.A.b). This is also similar to the remark made in the U.S. Technical Explanation accompanying the 2006 U.S. Model, in the context of the PE non-discrimination provision: *"For instance, it would not be a violation of the [PE non-discrimination provision] to require the foreign enterprise to provide information in a reasonable manner that may be different from the information requirements imposed on a resident enterprise, because information may not be as readily available to the Internal Revenue Service from a foreign as from a domestic enterprise."* To some extent, this statement could be seen as complementing what was said in 2.D.III.B about Art. 24(3): because residents and non-residents are, by

the clear text of Art. 24(4), which requires the deduction to be possible 'under the same conditions'. Clearly, where additional information requirements apply as regards payments made to non-residents, the deduction does not occur under the same conditions[791]. In theory, it could be possible that the Commentary actually suggests that non-resident recipients are not comparable to resident recipients with respect to information requirements because it is more difficult for the tax authorities to obtain information with respect to the former. However, it is clear that those difficulties are inherently connected with the non-residence of those recipients, with the result that that characteristic cannot be taken into consideration in the comparability-analysis. For that reason, it could be argued that this is actually a justification ground, similar to the justification grounds developed in the ECJ's case law (see also Part IV, 1.B).

A final point to be made is that Art. 24(4) is only concerned with the effect the payments might have on the taxpayer's taxable **profits**[792]. That is to say, the effect of Art. 24(4) is limited to the taxation of business profits as governed by Art. 7 (see supra, on the definition of the term 'an enterprise of a contracting State'). Since the deletion of Art. 14 OECD MC in 2000, self-employed persons are also covered by the provision. However, the provision does not apply to income from agriculture and forestry, as this is governed by Art. 6 OECD MC[793].

IV. Domestic rules on thin capitalisation

IV.A. General

In Arts. 9(1), 11(6) and 12(4), the OECD Model provides for rules on profit adjustment where there is a special relationship between payer and recipient. All of these provisions permit the denial of certain deductions when the relevant conditions are met. Art. 24(4) expressly states that it does not affect these rules. Consequently, it is not discriminatory for contracting States to apply such profit adjustment rules exclusively to cross-border transactions. However, Art. 24(4) remains applicable to the portion of the payments which would have been rendered between unrelated persons, i.e. the portion of the payments to which Arts. 9(1), 11(6) and 12(4) do not apply.

Given these restrictions, Art. 24(4) does not preclude the application of domestic thin capitalisation rules[794] – even if such rules apply exclusively to loans made by non-resident shareholders – on the condition that the requalification of the loan remains within the limits of Arts. 9(1) and 11(6). However, if such domestic rules do not comply with the limits laid down in Arts. 9(1) and 11(6), then they violate Art. 24(4) if they apply exclusively to non-resident creditors[795]. In other words, Art. 24(4) precludes a contracting State from applying thin cap

---

definition, different, it may be inevitable that different formalities are imposed on both. Art. 24 OECD MC does not prohibit such a distinction, as long as it does not lead to less favourable treatment of the subject of comparison. Similar observations were made in the context of Art. 24(1) in 2.B.VI.A.

[791] For an example, see Article 54 of the Belgian Income Tax Code, discussed in 2.E.IV.C.a.

[792] Or, where debt is concerned, on the taxpayer's taxable capital for purposes of capital taxation.

[793] See also supra, 2.D.I, on the scope of application of Art. 24(3).

[794] I will only deal with domestic measures that deny the deductibility of interest payments if a stated debt/equity ratio is exceeded. More specific mechanisms to counter hidden equity capitalisation, such as measures dealing with hybrid financing, will not be addressed here. See, in general, OECD, "Thin Capitalisation. Report of the Committee on Fiscal Affairs", 26 November 1986, paras. 11-12 (hereafter 'OECD Thin Cap Report').

[795] See Comm. OECD on Art. 24, para. 74.

rules exclusively to non-residents if these rules do not comply with Arts. 9(1) and 11(6)[796] (see however, hereafter, on the relationship between Art. 9(1) and 24(4)).

By implementing thin cap rules, States seek to prevent erosion of their domestic tax base which may occur when resident subsidiaries are financed by their non-resident parent companies with excessive levels of debt. In such cases, the resident subsidiary can deduct the interest, thus minimizing its taxable profits. In order to counter such constructions, most traditional thin cap rules prescribe fixed debt/equity ratios for shareholder financing. Generally speaking, two types of thin cap rules can be distinguished. On the one hand, rules which deny the deduction of the interest on the excessive debt but which do not alter the characterization of the payment as interest. On the other hand, rules which recharacterize the debt as equity and, consequently, the interest as a profit distribution. In the latter case, the interest is not deductible and the withholding tax for dividends applies.

Given the purpose of these measures, i.e. the prevention of erosion of the domestic tax base, they are typically restricted to loans granted by non-residents. This differential treatment seems to be at odds with Art. 24(4) OECD MC: payments made by residents are not deductible if they are made to non-residents, while they are deductible if they are made to residents. Nevertheless, Art. 24(4) is expressly made subject to the condition that Arts. 9(1) and 11(6) OECD MC do not apply.

Since Art. 11(6) only concerns the **amount of interest** not in accordance with the arm's length principle, it does not affect thin cap rules based on debt/equity ratios[797]. Art. 9(1) allows the contracting States to adjust the profits of an enterprise if that enterprise has entered into transactions with an associated enterprise on other than arm's length terms. Consequently, this provision allows a contracting State to apply thin cap rules in order to reduce the loan contracted by a resident company with its non-resident parent company to arm's length conditions. The excess, i.e. the portion of the loan that is not at arm's length, can be recharacterized for tax purposes with the result that the interest on the excess part is not deductible.

Domestic thin cap rules are thus in accordance with Art. 9(1) if they allow the taxpayer to demonstrate that the loan was contracted on an at arm's length basis[798]. While the use of a fixed debt/equity ratio leads to a shift in the burden of proof, that does not mean, in itself, that the domestic measure is contrary to Art. 9(1). It is possible that the fixed ratio is merely used as a 'safe haven', leaving the taxpayer the option to demonstrate that the transaction is at arm's length. On the condition that this option is sufficiently flexible for the taxpayer, there is no infringement of Art. 9(1)[799].

---

[796] On the relationship between domestic thin cap rules and Art. 24(5) OECD MC, see 2.F.IV. See also OECD Thin Cap Report, para. 66, where it is pointed out that, because Art. 24(5) is in such general terms, *"it must take second place to more specific provisions in the treaty. Thus Article 24(4) (referring to Article 9(1) and 11(6)) takes precedence over it in relation to the deduction of interest."* This statement was also included in the OECD Commentary (1992 Comm. OECD on Art. 24, para. 58) but it was replaced by a more detailed analysis in 2008 (see 2.F.IV).

[797] See Comm. OECD on Art. 11, para. 35: *"[Art. 11(6)] permits only the adjustment of the rate at which interest is charged and not the reclassification of the loan in such a way as to give it the character of a contribution to equity capital."*

[798] There is ample literature on the compatibility of domestic thin cap rules with Art. 9(1) OECD MC. See, for instance, IFA, *International aspects of thin capitalization*, Cah. Dr. Fisc. Int., Vol. LXXXIb, 1996; G. MICHIELSE, "Treaty aspects of thin capitalization", *Bull. IBFD* 1997, 565-573; L. DE BROE, *International tax planning and prevention of abuse*, Amsterdam, IBFD, 2008, 504-512.

[799] OECD Thin Cap Report, para. 79.

On the other hand, the domestic rule should not go further than reducing the loan to conditions that are at arm's length, that is to say, the taxable profits of the domestic enterprise should not be increased to an amount greater than the arm's length profit. The OECD Report on Thin Capitalisation points out that if the domestic measures go beyond this standard, Art. 24(4) precludes them from being applied exclusively to non-residents. In other words, if the adjustment under the domestic measure is not permitted by Article 9(1), then Art. 24(4) will prevent that adjustment from applying exclusively to interest paid to non-residents[800].

However, it should be stressed that Article 9(1) is restrictive, and not merely illustrative, in nature. If the provision were merely illustrative, it would allow an adjustment of profits to an amount greater than the arm's length amount. But because Art. 9(1) is restrictive in scope, rather than illustrative, it prevents adjustments to an amount greater than the arm's length amount[801]. Consequently, since Art. 9(1) already precludes adjustments to an amount exceeding that standard, there is no need to resort to Art. 24(4) in order to resolve this issue[802].

IV.B. 'Interest'

The observations made above relate both to domestic rules which leave the characterization as interest intact (i.e. which merely deny deductibility) and to rules which recharacterize the debt as equity, and, hence, the interest as a dividend. However, some specific observations are in order with regard to the latter category of rules. Since Art. 24(4) OECD MC refers to 'interest', the question arises whether that provision can apply to payments which have been recharacterized as profit distributions under domestic thin cap rules[803]. More specifically, a

[800] OECD Thin Cap Report, para. 66.

[801] In other words, the term 'where' in Art. 9(1) should be read as 'only where'. This is the majority view within the OECD and legal doctrine. See Comm. OECD on Art. 9, para. 3 (*"the application of rules designed to deal with thin capitalisation should normally not have the effect of increasing the taxable profits of the relevant domestic enterprise to more than the arm's length profit"*); OECD Thin Cap Report, paras. 29-30 and 50; F. DE HOSSON and G. MICHIELSE, "Treaty aspects of the thin capitalisation issue – A review of the OECD Report", *Intertax* 1989, 482; L. DE BROE, *o.c.*, 513; K. VOGEL, *o.c.*, 521-522; J.P. LAGAE and P. MATHIEU, "Prix de transfert entre sociétés belges et sociétés étrangères", in T. AFSCHRIFT (ed.), *Le droit fiscal international belge et l'évitement de l'impôt*, Brussels, Editions du Jeune Barreau de Bruxelles, 1996, 113. As a side-note, it should be pointed out that, given the restrictive nature of Art. 9(1), it precludes the application of such a profit adjustment between unrelated parties (within the meaning of that provision): see e.g. E. VAN DER BRUGGEN, "Werken Belgische anti-ontwijkingsmaatregelen door in een verdragssituatie?", *T.F.R.* 1994, 275; J. THILMANY, *Transferts indirects de bénéfices*, Diegem, Ced. Samsom, 1996, 129. Hereafter, I will only consider transactions between related parties. It should also be pointed out that the Belgian tax authorities do not agree with the view that Art. 9(1) is restrictive. Instead, they have taken the position that the provision is merely illustrative. As a result of this interpretation, Art. 9(1) would not preclude profit adjustments beyond the arm's length standard (see the Administrative Circular of 28 June 1999, No. AFZ 98/0003, *Bull. Bel.* 1999, 2481; confirmed by the Minister of Finance in Parliamentary Question No. 1083 of 12 January 2001 (De Clippele) *Vr. en Antw.* Senaat 2000-2001, 2-40, 2015).

[802] See also J. AVERY JONES, "The non-discrimination article in tax treaties: part 2", *B.T.R.* 1991, 445.

[803] In practice, this issue often loses its relevance because the applicable treaties deviate from the OECD MC. For instance, contracting States sometimes prefer not to include Art. 24(4) in their treaty (see e.g. the 1975 treaty between Belgium and Canada and the 1977 treaty between Canada and Italy). Moreover, a contracting State can expressly provide in the treaty that Art. 24(4) does not preclude the application of its domestic thin cap rules (see e.g. the reservation of France, Comm. OECD on Art. 24, para. 91 and the *Specialty Manufacturing* case, discussed in 2.E.IV.D.a) or that the provision does not apply to interest recharacterized as dividends under its domestic thin cap rules (e.g. Art. 24(4) of the 1996 Belgium/Ukraine treaty). Finally, a number of treaties define 'dividends' in Art. 10(3) as *"income, **even when paid in the form of interest**, which is treated as income from*

contracting State applying its domestic thin cap rules could argue that Art. 24(4) is not applicable because the payments in question are considered to be dividends instead of interest as a result of those rules.

The term ‘interest’ is not defined in Art. 24(4) OECD MC. There is a definition of ‘interest’ in Art. 11(3), but the expression ‘as used in this Article’ seems to indicate that the definition only applies for the purpose of Article 11[804]. Nevertheless, the expression ‘as used in this Article’ does not always mean that the definition of ‘interest’ in Article 11 should be restricted to that provision. If there is a sufficiently strong connection between the provision in which the term ‘interest’ is used and Article 11(3) – for instance where the provision in question concerns relief to be given by the residence State for tax withheld in the source State – the definition of Article 11 should be used. In such a case, the context requires requires the treaty definition to be used[805].

In the present case, there does not seem to be a sufficiently strong connection between Articles 11(3) and 24(4) to warrant the use of the definition of Article 11(3) when interpreting Article 24(4). The purpose of Article 11(3) is to define which income can be subject to withholding tax in the source State, while the purpose of Article 24(4) is to ensure that the payer of the interest is not discriminated against in the source State as regards deductibility. Since there is no strong connection between both provisions, it does not seem appropriate to use the definition of Article 11(3) when interpreting Article 24(4).

Accordingly, Article 3(2) comes into play: any term not defined in the treaty is interpreted in accordance with the domestic law of the contracting State applying the treaty, unless the context requires otherwise. In the present case, the contracting State applying the treaty is the source State (which applies its domestic thin cap rules). That would mean that domestic thin cap rules recharacterizing interest into dividends fall outside the scope of application of

---

shares by the domestic tax law of the State of which the paying company is a resident” (emphasis added; see e.g. the Belgian treaties with Algeria, Australia, Greece and Portugal). If the definitions of Articles 10(3) and 11(3) can be used when interpreting Art. 24(4) (on this question, see infra), the issue thus loses its relevance. As the domestic tax law of the paying company’s State of residence considers the payment to be a dividend, Art. 24(4) is not applicable (because that provision only refers to ‘interest’).

[804] In the OECD MC, some expressions are defined for the purposes of the whole treaty (see Articles 3 (general definitions), 4 (resident of a Contracting State) and 5 (permanent establishment); *“for the purposes of this Convention”*). Other expressions are defined in separate articles for the purpose of those articles (see Articles 10 (dividends), 11 (interest) and 12 (royalties): *“as used in this Article”*). The remarks made here also apply to the definitions of dividends and royalties given in Articles 10 and 12, respectively.

[805] On an analogous issue relating to the definition of dividends in Article 10, see J. AVERY JONES, “The definition of dividend in the double taxation relief article”, *B.T.R.* 1999, 167: *“the words ‘as used in this article’ are not there to restrict the definition to that article. It is suggested that the question of interpretation should be approached by assuming that the definition in the dividend article may apply elsewhere in the treaty but by asking first whether the context requires that definition should not be used in interpreting the particular provision, here the underlying credit provision. If the answer is that the definition should not be used, it follows that the term dividend in the underlying credit provision is undefined and so […] Article 3(2) of the Model applies. The internal law meaning of dividend in […] the state applying the underlying credit provision is therefore to be used to interpret it, unless the context otherwise requires. If the context does otherwise require, some other meaning has to be applied which is likely to be the definition in the dividend article, which brings us full circle back to the beginning of the analysis. One can therefore shorten the process by considering whether the context requires either the definition or internal law to be applied. The main aspect of the context is the connection between the dividend article and the underlying credit provision.”*

Article 24(4) since the payments in question are no longer considered to be interest under domestic law[806].

On the other hand, it has been argued that, in applying Art. 3(2) to domestic thin cap rules, the context requires a different interpretation. In particular, it has been suggested that the 'context' includes the object and purpose of Art. 24(4), that is to say, the removal of discrimination as regards deductibility. The result of this interpretation would be that the definitions of 'interest' in Art. 11(3) and 'dividend' in Art. 10(3) can be used when applying Art. 24(4) but only to the extent that the source State's domestic law would apply the recharacterization of interest into dividends equally to payments made to non-residents and residents[807].

Article 10(3) defines 'dividends' as *"income from shares […] or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident."* Given the reference to the source State's domestic law, it could therefore be argued that an interest payment which is recharacterized into a dividend under that State's thin cap rules falls under the definition of dividends in Art. 10(3). Consequently, if the source State's domestic law would apply the recharacterization of interest into dividends equally to payments made to non-residents and residents, Art. 24(4) would not apply since this provision does not refer to 'dividends'.

That approach is not very convincing: if the source State would apply its thin cap rules equally to residents and non-residents, there would be no discrimination and Art. 24(4) would not be relevant. Moreover, the OECD favours a narrow approach to the interpretation of the term dividends, that is to say, the expression 'other corporate rights' in Art. 10(3) should be limited to disguised equity contributions. Under that interpretation, Article 10 only covers interest on loans if the lender effectively shares the entrepreneurial risk run by the borrowing company, i.e. when the repayment depends largely on the success of that company's business[808]. An interest payment which is recharacterized into a dividend because a fixed debt/equity ratio is exceeded does not come within that definition. Accordingly, such a payment is not covered by the definition of 'dividend' in Article 10(3) and therefore retains its character as 'interest' under Article 11(3). As a result, Art. 24(4) would still be applicable to the thin cap rules, despite the reference in Art. 10(3) to the source State's domestic law.

Given the general rules of treaty interpretation, it seems preferable to disregard domestic definitions in the present case. Since Article 3(2) is a treaty provision, it is subject to the general rule of interpretation of Article 31 VC. Accordingly, the reference to domestic law in Article 3(2) OECD MC must be interpreted in good faith. For this reason, whenever the domestic law definition leads to a result that is unreasonable or unfair or violates the object

---

806 This position is taken by F. DE HOSSON and G. MICHIELSE, "Treaty aspects of the thin capitalisation issue – A review of the OECD Report", *Intertax* 1989, 483 and R. SOMMERHALDER, "Approaches to thin capitalization", *European Taxation* 1996, 93.

807 K. VAN RAAD, *o.c.*, 178; P. ADONNINO, "General Report", in IFA, *Non-discrimination rules in international taxation. Cahiers de droit fiscal international*, Vol. LXXVIIIb, Amersfoort, Sdu Fiscale & Financiële Uitgevers, 1993, 64.

808 Comm. OECD on Art. 10, para. 25, which concludes: *"Articles 10 and 11 do not therefore prevent the treatment of this type of interest as dividends under the national rules on thin capitalisation applied in the borrower's country. The question whether the contributor of the loan shares the risks run by the enterprise must be determined in each individual case in the light of all the circumstances […]"*. See also Comm. OECD on Art. 11, para. 19, Comm. OECD on Art. 23, para. 67 and OECD Thin Cap Report, para. 57.

and purpose of the treaty provision at issue, that definition should not be used. As pointed out earlier, the object and purpose of Article 24(4) is to ensure that a resident of a contracting State paying interest (or other disbursements) to a resident of the other contracting State is not discriminated against as regards deductibility. From that perspective, interpreting the term 'interest' according to domestic law, with the result that interest targeted by domestic thin cap rules are not considered to be interest, is not an interpretation in good faith in accordance with Article 3(2). In other words, a State that renders Article 24(4) inapplicable by relying on domestic fictions that recharacterize interest into dividends when interpreting the term 'interest' in Article 24(4) is not acting in good faith. Such an interpretation would deprive taxpayers of the protection from discrimination to which they are entitled under Article 24(4) OECD MC and would thereby impede the realization of that provision's object and purpose[809].

For that reason, it seems preferable to interpret the term 'interest' according to its ordinary (civil law) meaning, that is to say, compensation for funds borrowed, i.e. income generated by a debt claim. Such a broad definition is in line with the remarks made earlier, as regards the expression 'other disbursements' in Article 24(4). That expression should be interpreted broadly, as referring to all payments in the nature of a consideration for goods or services received. An interest payment that is recharacterized into a 'dividend' by virtue of a domestic fiction should still be considered as an 'other disbursement' within the meaning of Art. 24(4) OECD MC, i.e. a payment for a financial service.

IV.C. Examples

a. Article 54 ITC

1. The Belgian rule

As an example, consider Article 54 of the Belgian Income Tax Code. Pursuant to that provision, interest, royalties, other similar rights and the remuneration for activities and services do not constitute deductible expenses when they are paid, either directly or indirectly, to a non-resident or a foreign establishment which, according to the laws of the country where they are established, are not subject to income tax or are, with respect to those items of income, subject to a tax treatment which is considerably more favourable than that to which such income is subject in Belgium, unless the taxpayer demonstrates that the payments are made in respect of genuine and bona fide transactions and do not exceed the normal limits. The provision thus introduces a presumption that certain payments made to specified non-residents are inspired by tax avoidance motives. The taxpayer can rebut this presumption by establishing that the payments are made in respect of genuine transactions and that they do not exceed the standards of the open market.

The general rule in Belgian income tax law is that a taxpayer can only claim a deduction for business expenses if he demonstrates that the expenses were made with a view to obtain or retain taxable expenses. Moreover, the taxpayer is required to justify the amount of the expenses and their authenticity by means of written documents[810]. Article 54 starts from the same basic burden of proof, but that burden is made heavier because the taxpayer is required to establish that the payments were made at arm's length and that the transactions were

[809] L. DE BROE, *International tax planning and prevention of abuse,* Amsterdam, IBFD, 2008, 548.
[810] Article 49 Belgian Income Tax Code.

genuine[811]. Consequently, a taxpayer who makes a payment to a qualifying non-resident is placed at a disadvantage as compared to other taxpayers. The former taxpayer is unable to deduct the payment as a business expense, unless he rebuts the legal presumption. In contrast, other taxpayers can deduct the payments without rebutting any presumption, on the condition that they comply with the ordinary rules of proof of Article 49 ITC.

In other words, the tax authorities are required to demonstrate that all the conditions are satisfied for Article 54 to apply (e.g. qualifying payment, qualifying recipient, etc.). If the administration has met this burden of proof, it is up to the taxpayer to establish that the payments were made with respect to genuine and bona fide transactions and that they do not exceed the normal limits.

The first component, the requirement that the payments were made with respect to genuine and bona fide transactions, does not merely relate to the legal reality of the transaction, but rather to its economic or commercial justification. Accordingly, in order to meet this burden of proof, the taxpayer is required to demonstrate that the transactions correspond to an actual need of the company and that the expenses are justified by an industrial, commercial or financial necessity[812]. From that perspective, the burden of proof imposed by this first component of Article 54 does not differ from the general burden of proof under Article 49: in the latter case, the taxpayer is also required to demonstrate that the expenses were made with a view to obtain or retain taxable expenses and he must justify the amount of the expenses and their authenticity by means of written documents[813].

The second component, the requirement that the payments do not exceed the normal limits, refers to the arm's length standard. Accordingly, the taxpayer should establish that the amount of the payment is comparable to the amount that would have been paid under market conditions, i.e. conditions which would have been agreed upon between independent enterprises in comparable transactions under prevailing market circumstances[814]. This is where the taxpayer's burden of proof is made heavier as compared to a situation where Art. 54 ITC does not apply: apart from the basic burden of proof assumed under Article 49 ITC, the taxpayer now shoulders the additional burden of establishing the arm's length nature of the transaction.

2. Compatible with Art. 24(4)?

In response to a Parliamentary Question, the Belgian Minister of Finance stated that Article 54 ITC does not violate Art. 24(4) OECD MC. According to the Minister, Article 54 does not result in the disallowance of the deduction but only imposes a heavier burden of proof on the

---

[811] Moreover, the burden of proof is reversed as compared to the general transfer pricing rule of Article 26 ITC. Under that provision, it is up to the tax authorities to establish that there were 'abnormal or gratuitous advantages', in which case the profits transferred can be added back to the resident taxpayer's taxable profits. Article 26 ITC will be discussed in 2.E.IV.C.b.

[812] See e.g. *Parl. St.* Senaat 1953-54, No. 133, 3-4; Supreme Court 10 November 1964, *Pas.* 1965, I, 253; B. PEETERS and P. CAUWENBERGH, "Implementation of the internationally accepted at arm's length standard in Belgian tax law regarding multinational groups of companies", *Intertax* 1995, 568.

[813] See also S. VAN CROMBRUGGE, "Veinzingsvermoeden, aftrekbaarheidsvoorwaarden en bewijslast in Artikel 46 van het Wetboek der Inkomstenbelasting", *Fiskofoon* 1984, No. 47, 152-153.

[814] J.P. LAGAE and P. MATHIEU, "Prix de transfert entre sociétés belges et sociétés étrangères", in T. AFSCHRIFT (ed.), *Le droit fiscal international belge et l'évitement de l'impôt*, Brussels, Editions du Jeune Barreau de Bruxelles, 1996, 103. See also B. PEETERS and P. CAUWENBERGH, "Implementation of the internationally accepted at arm's length standard in Belgian tax law regarding multinational groups of companies", *Intertax* 1995, 568.

taxpayer, which is justified because of the privileged tax position of the recipient of the payment. Consequently, Article 54 is not intended to disallow or restrict the deduction for the sole reason that the payment is made to a non-resident[815].

The Minister's position is questionable, since Article 54 ITC does not apply to **resident** recipients that enjoy a privileged tax position. If the measure was truly aimed at preventing payments to recipients that enjoy a privileged tax position, it should also apply to such resident recipients[816]. More importantly, however, Art. 24 OECD MC does not offer the possibility to justify discriminatory treatment by relying, for instance, on the need to prevent tax avoidance (which is, presumably, the idea underlying the Minister's argument).

That being said, it should be pointed out that the Minister's statement is in line with the remark in the OECD Commentary that Art. 24(4) does not prohibit additional information requirements (which arguably includes a reversal of the burden of proof) with respect to payments made to non-residents *"since these requirements are intended to ensure similar levels of compliance and verification in the case of payments to residents and non-residents"*[817]. Yet, that position is difficult to reconcile with the clear wording of Art. 24(4) OECD MC, which requires the State of residence of the paying enterprise to allow the deduction of the payments made to a non-resident **under the same conditions** as if they were paid to a resident. Imposing a heavier burden of proof as regards payments made to non-residents constitutes a violation of this requirement. Nothing in the text of the provision indicates that additional information requirements do not fall under that prohibition.

On the other hand, that statement in the Commentary can be seen as an aspect of the comparability-test, in that it implies that payments made to non-residents are **not comparable** to payments made to residents. In particular, the tax authorities of the source State may have less information available with respect to non-resident recipients of payments than with respect to resident recipients. As that characteristic is relevant to the comparison, it could be argued that it renders the situations incomparable[818]. As a result, there is no discrimination if these situations are treated differently as regards information requirements. Applied to Art. 54 ITC: payments made to a non-resident are not comparable to payments made to a resident because the Belgian tax authorities do not have the necessary information about the former to ascertain whether the payments are made under at arm's length conditions.

Of course, the counter-argument would be that the lack of information as regards non-residents is inherent in their non-residence. That is to say, because the characteristic in question (the lack of information) is inextricably linked to the comparative attribute (the recipient's non-residence), it should be left out of the comparability-analysis[819]. On this point, see Part III, 2.F.III.

3. Entitlement to Art. 24 in cases of treaty abuse

[815] Parl. Question No. 1087, 14 October 1997, *Bull. Bel.* 1998, 1053-1055.
[816] See also P. BIELEN and H. VERSTRAETE, "Non-discriminatie", in B. PEETERS (ed.), *Het Belgisch-Nederlands dubbelbelastingverdrag: een artikelsgewijze bespreking*, Ghent, Larcier, 2008, 688.
[817] Comm. OECD on Art. 24, para. 75.
[818] That is to say, the lack of information concerning the recipient of the income is a relevant characteristic for the purpose of a domestic rule that governs the information requirements imposed on resident taxpayers seeking to deduct payments made to either residents or non-residents.
[819] See the flowchart in Part I, B.II.

In this context, it is also important to address the entitlement to Art. 24 OECD MC in situations involving treaty abuse. Particularly, it could be suggested that a taxpayer cannot invoke the non-discrimination provision of a tax treaty in cases of abuse. More specifically, a contracting State could argue that its domestic thin cap rules are not targeted by Art. 24(4) because that provision should not be construed in such a way that it allows or encourages tax avoidance.

However, countering treaty abuse is not the purpose of Art. 24. A number of specific clauses deal with this issue (e.g. beneficial ownership, limitation on benefits clauses, etc.). There is no reason why the application of Art. 24 should be made subject to the implicit condition that the taxpayer's behaviour was not abusive. If the conditions of the specific anti-abuse rules are not fulfilled, the application of Art. 24 should not be denied on grounds of abuse. There is no general principle in tax treaty law that a taxpayer loses his entitlement to the treaty benefits in cases of abuse[820]. Nor is there any indication in the treaty that the interpretation of Article 24 is subject to an implicit requirement that the transaction is not aimed at tax avoidance. This conclusion is supported by the statement in the Commentary that it is open to contracting States to modify Art. 24(4) OECD MC in bilateral conventions *"to avoid its use for tax avoidance purposes"*[821]. However, absent a specific reservation in the treaty to that effect, there is no reason why Art. 24(4) should not apply to discriminatory rules that are 'justified' because they aim at combating tax avoidance, particularly because Article 24(4) OECD MC specifically lists the instances where it permits discrimination (i.e. where Art. 9(1), 11(6) or 12(4) applies)[822].

Therefore, in the absence of a specific treaty provision that allows the application of Article 54 notwithstanding the non-discrimination provisions in the treaty, Article 54 is contrary to Art. 24(4) of the applicable treaty[823]. As a result, that provision should not be applied to payments made by Belgian residents to a resident of a State with which Belgian has concluded a treaty which includes a provision analogous to Art. 24(4) OECD MC.

That being said, it should also be verified whether Art. 9(1) affects this conclusion, because Article 24(4) does not apply where Art. 9(1) applies. In principle, it seems that Article 54 ITC does not infringe Art. 9(1) OECD MC[824]. As pointed out earlier, Article 54 strengthens the

---

[820] Recent case law may cast some doubt on this position. Compare, for instance, District Court of Tel-Aviv 30 December 2007, *Yanko-Weiss Holdings*, 10 *ITLR* 524; Conseil d'Etat 29 December 2006, *Bank of Scotland*, 9 *ITLR* 683 and Swiss Federal Court 28 November 2005, *A Holding ApS*, 8 *ITLR* 536. Since this is a general issue of treaty interpretation that goes well beyond the scope of the present study, it will not be discussed here. For an extensive analysis, see L. DE BROE, *International tax planning and prevention of abuse,* Amsterdam, IBFD, 2008, 301-459.

[821] Comm. OECD on Art. 24, para. 73.

[822] See also L. DE BROE, *International tax planning and prevention of abuse*, Amsterdam, IBFD, 2008, 571.

[823] See also J. ROELS, "Non-discriminatie", in B. PEETERS (ed.), *Het nieuwe Belgisch-Nederlands dubbelbelastingverdrag*, Ghent, Larcier, 2002, 567-568; I. BEHAEGHE, "Discriminatieverbod – Betaling van vergoedingen aan niet-inwoners", *Fisc. Koer.* 1998, 216-217; E. SCHOONVLIET, *Handboek internationaal fiscaal recht*, Kalmthout, Biblo, 1996, 293; L. DENYS, "Over het prima-facie parallellisme van sommige bepalingen in belastingverdragen en intern fiscaal recht", *Fiskofoon* 1978, No. 13, 21.

[824] Obviously, a potential conflict can only arise where both provision apply at the same time. Art. 54 ITC applies to payments made to residents of tax havens or a country where they enjoy a beneficial tax regime. In principle, Belgium does not conclude tax treaties with tax havens, so there is nothing to preclude the domestic provision from being applied. Moreover, it should be pointed out that the wording of Articles 9(1) and 24(4) differs. While Art. 9(1) refers to **two enterprises** (i.e. one in each contracting State), Art. 24(4) concerns payments from **an enterprise** of a contracting State to **a resident** of the other contracting State. Consequently, the recipient of the payment does not need to carry on an enterprise in order to fall under the scope of application of Art. 24(4). The result of this difference in wording is that a domestic measure on profit adjustments that

burden of proof imposed upon the taxpayer be requiring him to establish that the transaction took place under arm's length conditions. If the taxpayer is able to satisfy this burden of proof, he is able to deduct the expenses. The OECD Commentary is not entirely clear whether the imposition of this additional burden of proof is in accordance with Art. 9(1) OECD MC. It merely points out that a number of States consider that Article 9 is not restrictive but merely illustrative (a view which I do not agree with, see supra) – which would mean that that provision does not preclude States from making profit adjustments under domestic rules and conditions that differ from those of Art. 9 – and that *"almost all Member countries consider that additional information requirements which would be more stringent than the normal requirements, or even a reversal of the burden of proof, would not constitute discrimination within the meaning of Article 24"*[825]. The OECD Thin Cap Report observes that a reversal of the burden of proof by applying a fixed debt/equity ratio and allowing the taxpayer to demonstrate the arm's length nature of the transactions is, in principle, not contrary to Art. 9(1). However, the lower the ratio and the more rigid the practice followed in applying it, the more serious the danger of producing a result which is inconsistent with the arm's length principle[826].

The Belgian tax authorities take the position that Article 54 ITC is a special rule of proof that does not affect the way in which the taxable profit is determined. As a result, that provision is not affected by Article 9 OECD MC[827]. A similar position was taken by the Antwerp Court of First Instance in a case of 2007. According to the Court, Article 54 ITC *"does not add any additional or other conditions to those mentioned in Article 9"*. Therefore, Article 54 ITC does not violate Art. 24(4), as the latter provision is expressly made subject to the application of Article 9(1)[828]. Similarly, several authors have argued that Art. 24(4) is not violated because the end result of the application of Art. 54 ITC is that the taxpayer's taxable basis is adjusted up to the arm's length standard. As a result, the discrimination is set aside by the exception in Art. 24(4) for the correct application of the arm's length test under Art. 9(1)[829].

However, those arguments start from the assumption that Article 9(1) **applies** to the heavier burden of proof imposed upon the taxpayer by virtue of Art. 54 ITC. Art. 24(4) OECD MC applies except **where Art. 9(1) applies** (or Art. 11(6), or Art. 12(4)). It is not entirely clear to me whether that is the case. Unquestionably, the **end result** reached by the application of Article 54 ITC is in accordance with Art. 9(1): the taxpayer is able to deduct the expenses if

affects payments made by a resident carrrying on an enterprise to a non-resident not carrying on an enterprise does not fall under Article 9(1) but does fall under Art. 24(4). Therefore, in situations where Art. 54 ITC applies to such payments, it cannot be said to fall under Art. 9(1) with the result that the reservation in Art. 24(4) is ineffective. These observations also apply with respect to Article 26 ITC, which will be discussed hereafter. However Art. 11(6) and 12(4) do not refer to enterprises, but to **the payer** and **the beneficial owner**, which also includes, for instance, individuals. As the scope of these provisions is broader than that of Art. 9(1), it is possible that they cover the domestic measure, even though Art. 9(1) does not apply.

825 See Comm. OECD on Art. 9, para. 4.

826 OECD Thin Cap Report, para. 79.

827 Official Commentary on Belgian tax treaties, 9/5. See also the Administrative Circular of 28 June 1999, No. AFZ 98/0003, *Bull. Bel.* 1999, 2481, referred to above, where the tax authorities set out their position that Art. 9(1) is merely illustrative in nature and therefore does not preclude Belgium from making profit adjustments under conditions that differ from those of Article 9(1).

828 Antwerp Court of First Instance 3 October 2007, *F.J.F.* 2008, No. 2008/255, 967-970: *"Verder voegt Artikel 54 WIB92 geen bijkomende of andere voorwaarden toe dan deze vermeld in Artikel 9 van het Belgisch-Iers dubbelbelastingverdrag. De toepassing van Artikel 54 schendt derhalve Artikel 24 § 5 van het Belgisch-Iers dubbelbelastingverdrag niet."*

829 E.g. L. DE BROE, *International tax planning and prevention of abuse*, Amsterdam, IBFD, 2008, 571; K. BRONSELAER and W. HEYVAERT, "Non-discrimination", in A. VAN DE VIJVER, *The new US-Belgium double tax treaty*, Ghent, Larcier, 2008, 516.

they are made under arm's length conditions[830]. But that does not mean that Article 54 ITC **in itself** is in accordance with Article 9(1). Article 9(1) only deals with the extent to which a contracting State can make profit adjustments, it does not say anything about the procedure to be followed when making those adjustments, nor does it specify who should shoulder the burden of proof. From that perspective, I find it questionable to argue that Article 9(1) 'applies' to the burden of proof imposed by Art. 54. It is true that that burden of proof is **not contrary** to Art. 9(1), but that is not the same as saying that Art. 9(1) applies and that, therefore, Art. 24(4) is inapplicable.

In other words, Art. 54 only adjusts the division of the burden of proof and the end result of its application is in accordance with Art. 9(1). So either the taxpayer meets his burden of proof and he is entitled to deduct the expense (which is at arm's length), or he fails to meet the burden of proof and his profit is adjusted with the non-arm's length portion. Both outcomes are in accordance with Art. 9(1). Only if the tax authorities were to deny a deduction for the full amount, instead of merely disallowing the deduction for the part of the expense which is not at arm's length, would the result violate Art. 9(1). But Art. 54 ITC is not applied that way[831]. The fact that the outcome of a domestic provision does not violate Art. 9(1), does not mean that that provision falls under the scope of application of Art. 9(1). The latter provision simply does not saying anything on the matter so it would be misleading to say that Art. 9(1) 'applies'.

> On the other hand, one could argue that, because the end result is consistent with (that is to say, not contrary to) Art. 9(1), it is also consistent with Article 24(4). However, of all the paragraphs of Article 24, the deduction non-discrimination clause seems to be the least concerned with the end result. Unlike the other paragraphs, Art. 24(4) does not refer to 'taxation that is more burdensome' (or 'not less favourable'). The provision merely requires the conditions for deductibility to be the same. Of course, requiring the same conditions for deductibility will generally produce the same end results as regards deductibility, but the opposite is not necessarily true. Article 54 ITC illustrates this: even though the end result is the same for the subject and object of comparison (deductibility of an arm's length amount), the conditions under which that end result are reached are different. In my opinion, that is contrary to Art. 24(4).

This illustrates that there is an overlap between Arts. 9(1) and 24(4) OECD MC as regards domestic thin cap rules, but also that the overlap is only partial. Article 9(1) determines to what extent a contracting State is allowed to make profit adjustments as regards transactions between associated enterprises. In that field, Art. 24(4) is inapplicable since its application is expressly excluded where Art. 9(1) applies. However, there are issues involving thin capitalization where Article 9(1) does not apply, such as the division of the burden of proof. There is no reason why Art. 24(4) should not apply to those issues. The additional burden of proof is unmistakably a condition for deductibility which applies to payments made to non-residents and not to payments made to residents. On the other hand, the lack of information available as regards a non-resident recipient may be a relevant characteristic that renders the situation incomparable to that where the payment is made to a resident recipient. However, it

[830] See also J. THILMANY, *Transferts indirects de bénéfices*, Diegem, Ced. Samsom, 1996, 131; E. VAN DER BRUGGEN, "Werken Belgische anti-ontwijkingsmaatregelen door in een verdragssituatie?", *T.F.R.* 1994, 274-276.
[831] That is to say, it should not be applied that way. In the past, the Belgian tax authorities have taken the approach that the entire deduction can be disallowed but the Supreme Court has condemned this position: see Supreme Court 27 September 1966, *Pas.* 1967, I, 121.

seems that that characteristic is the inevitable consequence of the comparative attribute, with the result that it should be left out of the comparability-analysis.

b. Article 26 ITC

As a second example, consider Art. 26 of the Belgian Income Tax Code, a transfer pricing provision that allows the Belgian tax authorities to adjust the taxable profit of Belgian resident taxpayers. Pursuant to Article 26 ITC, ‘abnormal or gratuitous advantages’ granted by a Belgian resident company are included in the taxable base of the company granting the advantage, unless it can be demonstrated that the advantage is taken into consideration for the purpose of determining the beneficiary’s taxable base. In addition, Article 26 ITC provides that, irrespective of the foregoing, abnormal or gratuitous benefits granted by a resident company must always be included in the taxable base of that company in three situations (see infra)[832].

According to domestic case law, an advantage refers to any kind of enrichment without adequate consideration. Such an advantage is deemed to be abnormal where it has been granted without normal consideration, under abnormal economic or financial conditions or against the commonly prevailing market and/or commercial practices at the time of grant. An advantage is deemed to be gratuitous if it is granted in the absence of a contractual obligation thereto or without any consideration.

The tax authorities are required to establish that all the conditions for the application of Article 26 ITC are met. However, the provision expressly provides that it yields to Article 54 ITC. This alleviates the burden of proof assumed by the tax authorities, since under Article 54 ITC the deduction of qualifying payments as business expenses is excluded and the burden of proof as regards the arm’s length character of the payments is shifted to the taxpayer (see supra).

Assuming that the conditions for the application of Article 26 ITC are met, it is up to the taxpayer to demonstrate that the profit adjustment cannot be applied because the benefits in question are taken into consideration for the purpose of determining the beneficiary’s taxable base. This exception generally applies where the benefit is granted to a resident recipient[833], but it can also be applied where the beneficiary is a non-resident if it can be established that the benefit is taken into consideration for the purpose of determining the beneficiary’s taxable income in its State of residence[834]. However, the importance of the exception in situations involving a non-resident recipient is negligible: as will be pointed out hereafter, the taxpayer is unable to rely on this exception where the benefit is granted to a related non-resident. Consequently, the exception only applies in situations involving unrelated non-residents, in which case it is unlikely that the resident would grant abnormal or gratuitous advantages.

---

[832] For an extensive discussion of this provision, see e.g. J. MALHERBE, *Droit fiscal international*, Brussels, Larcier, 1994, 579-596; L. DE BROE, *International tax planning and prevention of abuse*, Amsterdam, IBFD, 2008, 78-93.

[833] See Parliamentary Question No. 174 of 12 June 1990 (Cooreman), *Vr. en Antw.* Senaat 1990-1991, 1640: Article 26 ITC does not apply where the advantage is granted to a resident company subject to the corporate income tax, since the advantage is taken into consideration for the purpose of determining the beneficiary’s taxable base.

[834] Parliamentary Question No. 472 of 6 October 2000 (Eerdekens), *Bull. Bel.* 2001, 1613-1614: the payer can rely on this exception to Article 26 ITC if the advantage is granted to a non-resident who is (1) not related to the payer, (2) not established in a tax haven and (3) who does not have ‘common interests’ with a non-resident falling under (1) or (2).

Article 26 ITC provides that, where the resident taxpayer grants an abnormal or gratuitous advantage to one of three categories of recipientes, he cannot rely on the exception described above. All three of these categories concern non-residents. The first category of recipients are related non-resident companies, i.e. non-resident companies with which the resident company is, directly or indirectly, in a relationship of mutual dependence. The second category concerns non-residents who, according to the laws of the country where they are established, are not subject to income tax or are subject to a tax treatment there which is considerably more favourable than that to which the Belgian transferor is subject. Finally, the third category is made up of unrelated non-residents that have 'common interests' with non-residents falling in the first or second category.

Thus, if a resident taxpayer grants an abnormal or gratuitous advantage to a beneficiary falling in one of those three categories, he cannot demonstrate that the advantage in question is taken into consideration for the purpose of determining the recipient's taxable base. In contrast, if the advantage were granted to a resident beneficiary, such a rebuttal would be available. At first sight, this differentiation seems to fall foul of Art. 24(4) but, once again, Articles 9(1) and 11(6) should be considered first.

First, Article 9(1) precludes the tax authorities from making a profit adjustment that goes beyond the arm's length standard. However, that will not give rise to many problems under Art. 26 ITC, since the expression 'abnormal and gratuitous advantages' is inspired by the arm's length principle and is generally interpreted in accordance with that principle[835].

Secondly, Article 9(1) precludes Art. 26 ITC from being applied in situations where the enterprises involved are not 'associated enterprises' within the meaning of the former provision. According to Art. 9(1), two enterprises are associated where *"an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State"*, or where *"the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State"*. The Commentary further notes that it concerns parent and subsidiary companies and companies under common control[836].

As pointed out earlier, the first category of situations in which the resident taxpayer is unable to set aside the application of Art. 26 ITC concerns non-resident companies with which the resident company is, directly or indirectly, in a relationship of mutual dependence. The scope of application of this reservation is therefore broader than the 'associated enterprises' under Art. 9(1). As a result, the application of Article 26 ITC in situations involving a treaty that contains a provision analogous to Art. 9(1) OECD MC should not go beyond the limits set out that provision.

> It should be pointed out that Art. 11(6) uses the expression 'a special relationship', which is broader than 'associated enterprises' in Art. 9(1). According to the Commentary, this also includes *"any community of interests as distinct from the legal relationship giving rise to the payment of the interest"*[837]. It is therefore possible that the deductibility of excessive interest payments is disallowed under Art. 26 ITC (or under Art. 54 ITC, for that matter) in a situation where the relationship between payer and beneficiary qualifies as a 'special

[835] See the discussion in L. DE BROE, *o.c.*, 77-81.
[836] Comm. OECD on Art. 9, para. 1.
[837] Comm. OECD on Art. 11, para. 34.

relationship' within the meaning of Art. 11(6) but not as an 'association' within the meaning of Art. 9(1). In such a case, Art. 26 ITC can be applied in a treaty situation, even though it goes beyond the rules set out in Art. 9(1): Art. 11(6) provides a legal basis for the profit adjustment in that case. Therefore, disallowing the deductibility of excessive interest under Art. 26 ITC is only disallowed where it applies to parties that are not associated enterprises within the meaning of Art. 9(1) and there is no special relationship between them within the meaning of Art. 11(6).

Nevertheless, the Belgian tax authorities have taken the position that the expression 'associated enterprises' should be interpreted broadly and that, therefore, Art. 9(1) does not restrict the application of Art. 26 ITC[838]. However, that position is overly broad and should be dismissed[839]. As a result, Art. 9(1) precludes the application of Art. 26 where the parties involved are not 'associated' within the meaning of the treaty. The same position should be taken with respect to the second and third categories of non-residents referred to in Art. 26 ITC: to the extent that those non-residents are not 'associated' within the meaning of Art. 9(1) OECD MC, Art. 26 ITC cannot be applied in a situation governed by an OECD MC-style tax treaty[840].

Issues concerning Article 24(4) do not arise where Art. 9(1) precludes the application of the domestic rule. As pointed out earlier, there is no point in applying Art. 24(4) if it is established that a domestic rule is found to violate Art. 9(1) and should therefore be set aside. Moreover, Art. 24(4) does not apply where the domestic rule provides for a profit adjustment to the arm's length standard, that is to say, where Art. 9(1) 'applies'. Therefore, issues concerning Art. 24(4) only arise if two conditions are simultaneously fulfilled: *(a)* the domestic rule is not precluded by Art. 9(1) and *(b)* Art. 9(1) does not apply[841].

Applied to Art. 26 ITC, that leads to the following conclusion. First, Art. 9(1) precludes the application of the domestic provision where it is not applied to associated enterprises within the meaning of that provision. Consequently, the analysis under Art. 24(4) only concerns

[838] Official Commentary on Belgian tax treaties, 9/3, where its pointed out for instance that the expression 'participation in the capital' in Art. 9(1) also includes e.g. the granting of loans.
[839] See L. DE BROE, *o.c.*, 515.
[840] See also J.P. LAGAE and P. MATHIEU, "Prix de transfert entre sociétés belges et sociétés étrangères", in T. AFSCHRIFT (ed.), *Le droit fiscal international belge et l'évitement de l'impôt*, Brussels, Editions du Jeune Barreau de Bruxelles, 1996, 116-117. Moreover, Art. 9(1) only allows tax authorities to make a profit adjustment if the deviation from arm's length conditions was **caused** by the association between the enterprises involved (see the wording of Art. 9: *"… but, **by reason of those conditions** have not so accrued…"* and Comm. OECD on Art. 9, para. 2: *"… if, **as a result of the special relations** between the enterprises the accounts do not show the true taxable profits arising in that State"*; emphasis added). Art. 9 thus requires the tax authorities to establish that the special relationship between the enterprises caused them to deviate from the arm's length standard. Article 26 ITC does not impose such a burden of proof on the Belgian tax authorities. They are only required to demonstrate that the conditions of that provision are met, without any proof as to the causal relationship between the non-arm's length character of the transaction and the affiliation between the enterprises. From that perspective, it seems Art. 26 ITC falls foul of Art. 9(1) OECD MC (e.g. J. THILMANY, *Transferts indirects de bénéfices*, Diegem, Ced. Samsom, 1996, 129-130; C. AMAND, a.o. "Fiscaal Jaaroverzicht 1992", *Fisc. Koer.* 1993, 41-42). However, it could also be argued that causality can be assumed to exist if there is an association and at the same time a deviation from the arm's length standard. On the condition that domestic procedural law allows for such an assumption, there should be no violation of Art. 9(1) OECD MC (K. VOGEL, *o.c.*, 527). If that is indeed the correct interpretation of Art. 9(1), this aspect of Article 26 ITC is not problematic. The same remarks are in order with regard to Art. 11(6) OECD MC, to the extent that that provision applies to Art. 26 ITC.
[841] The same is true with regard to excessive interest payments that may fall under Art. 11(6): issues concerning Art. 24(4) only arise if the domestic rule is not precluded by Art. 11(6) and Art. 11(6) does not apply. As pointed out earlier, the expression 'special relationship' in Art. 11(6) is broader than the term 'associated enterprises' in Art. 9(1). Consequently, Art. 11(6) may apply to Art. 26 ITC in situations where Art. 9(1) does not apply.

payments made to associated enterprises. Assuming that the expression ‘abnormal or gratuitous advantages’ is interpreted in accordance with the arm’s length principle (see supra), the measure applies identically to payments made to associated residents and to associated non-residents: both suffer a profit adjustment if the advantages granted exceed the arm’s length standard.

As was the case for Art. 54 ITC, the question then arises whether the provisions of Art. 9(1) ‘apply’. Unlike Art. 54, however, Article 26 ITC does not simply impose a heavier burden of proof on residents making payments to associated non-residents. Instead, Article 26 makes it entirely impossible for the payer to avoid the profit adjustment. In contrast, advantages granted to an associated resident will not give rise to a profit adjustment if the payer demonstrates that the advantage is included in the recipient’s taxable base[842].

Once again, therefore, the end result of the application of the domestic provision is in accordance with Art. 9(1) OECD MC: the resident taxpayer’s profits are adjusted to reflect an arm’s length transaction with the associated non-resident. However, Art. 26 ITC also provides that such a profit adjustment can be avoided if the advantage was granted to a related resident and it was included in the recipient’s taxable base. That condition has nothing to do with the arm’s length nature of the payment. Consequently, it cannot be said that Article 9 ‘applies’ to that condition. Rather, it is an additional possibility for payments made to residents to avoid the profit adjustment, which is not available for payments made to non-residents. Even if it could be said that Article 9(1) ‘applies’ if the end result of Art. 26 ITC is in accordance with that provision (and, therefore, that Art. 24(4) cannot be applied), the situation discussed here is different. The inapplicability of the profit adjustment where the advantage is included in the resident recipient’s taxable base is entirely separate from the ‘end result’ described above (an arm’s length profit adjustment for payments made to non-residents). Regardless of the fact that the payment was not at arms’ length, the resident payer can avoid the profit adjustment if the advantage was granted to a resident, while no such option is available if the advantage was granted to a non-resident. Clearly, this differentiation constitutes discrimination contrary to Art. 24(4) OECD MC.

IV.D. Case law

a. Millennium Infocom Technologies[843]

The taxpayer was a company resident in India that leased servers from a U.S. resident company. Under Indian domestic tax law, a resident taxpayer paying fees for technical services to a non-resident was required to withhold Indian tax on those fees. The taxpayer was of the opinion that the services in question were not in the nature of technical services and that, therefore, no tax should be withheld in India.

In his tax return in India, the taxpayer sought to deduct the lease payments as deductible business expenses. However, the Indian tax authorities dismissed this claim on the basis of Sec. 40(a)(i) of the Indian Income Tax Act 1961. According to that provision, when a payment made to a non-resident is subject to tax in India and the payer has not withheld the applicable Indian withholding tax, that payer cannot deduct the payment as a business

[842] And, as pointed out earlier, that will always be the case where the recipient is a resident company subject to corporate income tax.
[843] Indian Income Tax Appellate Tribunal 31 January 2008, *Millennium Infocom Technologies v ACIT*, No. 2008-21 SOT 152, IBFD Tax Treaty Case Law Database.

expense. In the present case, the Indian tax authorities thus denied the deductibility on the grounds that the taxpayer had not withheld Indian tax when making the lease payments.

Before the Appellate Tribunal, the taxpayer argued that Sec. 40(a)(i) fell foul of the deductibility non-discrimination provision in the Indian/U.S. tax treaty[844] because the domestic limitation on deductibility applied exclusively to payments made to non-residents. As there was no special relationship between the taxpayer and the recipient of the income, the reservation in that provision as regards royalty payments between related parties did not apply.

The Appellate Tribunal decided in favour of the taxpayer. The Tribunal noted that the disallowance of the deduction where tax was not withheld at source only applied for payments made to a non-resident. In contrast, a similar payment to a resident did not result in a disallowance of the deduction where tax was not withheld at source. According to the Tribunal, this fell foul of the requirement in the deductibility non-discrimination provision of the tax treaty that payments made to non-residents should be deductible under the same conditions as payments made to residents. As a result, there was discrimination contrary to the treaty.

b. Specialty Manufacturing[845]

The taxpayer was a Canadian resident company that paid interest to two related U.S. resident companies. The U.S. companies had borrowed money from a U.S. bank and loaned this sum to the Canadian taxpayer. The taxpayer paid the same interest rate as the U.S. companies paid to the U.S. bank.

In Canada, a domestic thin cap rule applied according to which no interest deduction was available for loans attracted from non-residents if the debt/equity ratio exceeded 3/1[846]. Since the taxpayer's debt/equity ratio was significantly higher than 3/1, the Canadian tax authorities disallowed most of the deductions pertaining to the interest paid to the related U.S. companies.

The taxpayer objected against this assessment, relying on Article IX(1) of the 1980 Canadian/U.S. treaty (which corresponds to Article 9(1) OECD MC). Furthermore, Article XXV(7) of the treaty was identical to Article 24(4) OECD MC, but Article XXV(8)(a) provided as follows: *"The provisions of paragraph 7 shall not affect the operation of any provision of the taxation laws of a Contracting State relating to the deductibility of interest and which is in force on the date of signature of this Convention (including any subsequent modification of such provisions that does not change the general nature thereof)"*[847]. The Canadian thin cap rule at issue, was in force on the date of signature of the 1980 treaty.

Referring to the OECD Commentary on Article 9, the taxpayer argued that Article IX(1) of the Canadian/U.S. treaty only allowed Canada to disallow the deduction if the interest was not

[844] Art. 26(3) of the 1989 treaty, which is, for the purpose of the present case, identical to Art. 24(4) OECD MC 1977.
[845] Tax Court of Canada 25 August 1997, *Specialty Manufacturing Ltd. v The Queen* (1997) 1 *C.T.C.* 2095.
[846] Subsection 18(4) of the Canadian Income Tax Act.
[847] On the interpretation of the expression *"any subsequent modification of such provisions that does not change the general nature thereof"*, see Tax Court of Canada 3 December 1993, *Ramada Ontario Ltd. v The Queen* (1994) 1 *C.T.C.* 2130.

at arm's length. Accordingly, that provision precluded Canada from disallowing any interest deduction if a Canadian company paid an arm's length rate of interest to a related U.S. company. In the present case, the interest rate paid by the taxpayer was an arm's length rate since it was identical to the interest rate paid by the U.S. companies to the U.S. bank. As a result, the Canadian tax authorities could not rely on the thin cap rule at issue to disallow the deduction.

The tax authorities contended that the more specific wording of Article XXV(7) and (8), dealing specifically with interest, should apply rather than the general provisions of Article IX, dealing with many types of transfers between residents and non-residents. Since XXV(8) of the treaty rendered Article XXV(7) inapplicable as regards thin cap rules existing at the date of signature, the treaty did not prevent the application of the Canadian thin cap rules. The taxpayer disagreed, arguing as follows: *"Article XXV(7) of the 1980 Treaty does not apply simply because of Article XXV(8)(a). Article XXV(7) is not the exclusive defence to a subsection 18(4) assessment. […] Articles IX(1) and XXV(7) are two independent defences to a subsection 18(4) assessment and the fact that the Article XXV(7) is taken away by Article XXV(8)(a) has no bearing on the validity of the Article IX(1) defence. […] Article XXV(7) provides that if an adjustment is in accordance with Article IX(1), that adjustment is not discriminatory for purposes of Article XXV(7). […] This implies that some adjustments may not be in accordance with Article IX(1) because the parties may already be dealing as if they were at arm's length. In that case […] the appellant does not need to, and this case does not, rely on Article XXV(7) to prevent the application of subsection 18(4); the adjustment has already been prevented by Article IX(1). […] The appellant's counsel also stated that Articles IX(1) and XXV(7) together indicate that domestic adjustments to the profits of one State's enterprise (e.g. as contemplated by subsection 18(4)) are subject to a dual restriction, the first being the arm's length criterion in Article IX(1) and the second the non-discrimination rules of Article XXV. The fact that the second restriction is eliminated by Article XXV(8)(a) says nothing about the continued restriction of Article IX(1)."*

The Tax Court dismissed the taxpayer's arguments. After pointing out that Article XXV(7) of the treaty precluded the contracting States from discriminating residents of the other State with respect to the deductibility of interest, royalties and other disbursements, the Court notes: *"One of the exceptions to this non discrimination provision is where Article IX(1) applies. Thus while Article XXV restrains discriminatory legislation, Article IX(1) permits a State to discriminate where related persons of both States do not deal with each other at arm's length. I cannot agree with appellant's counsel that whenever related parties do deal with each other at arm's length, Article XXV cannot apply."*

The Court then holds that Article XXV(7) and Article IX(1) should be read together. Even though Article XXV(7) prohibits discrimination, discrimination is permitted in circumstances where Article IX(1) applies. Article IX(1) permits the States to make adjustments to reflect arm's length transactions. Article IX(1) does not prevent the States from regulating transactions between related persons who deal with each other on an arm's length basis. Like Art. 9(1) OECD MC, that provision does not have any effect when associated enterprises transact with each other on normal open market terms. Where there is discriminating legislation, Article XXV(7) would apply.

The Court finally refers to the Technical Explanation accompanying the 1980 Canadian/U.S. treaty, where Art. XXV(8) is clarified as follows: *"Paragraph 8 provides that, notwithstanding the provisions of paragraph 7, a Contracting State may enforce the* *provisions of its taxation laws relating to the deductibility of interest, in force on September 26, 1980, or as modified subsequent to that date in a manner that does not change the general nature of the provisions […].* ***Thus Canada may continue to limit the deductions for interest paid to certain nonresidents as provided in section 18(4) of Part 1 of the Income Tax Act"*** (emphasis added).

According to the Court, it is therefore clear that the drafters of the 1980 treaty did not intend to limit the application of subsection 18(4) in force on the date of signature of the treaty: *"there would be no reason for the 1980 Treaty to include Articles XXV(7) and (8) and for the Technical Interpretation of Article XXV(8) to conclude as it does if it was contemplated that Article XXV(7) would have no application if Article IX applied. Neither Canada nor the United States intended that in any case Article IX would apply to thin capitalization transactions where Article XXV(7) did."*

The Court thus concluded that the treaty did not preclude Canada from applying the thin cap rule at issue. The decision was subsequently confirmed by the Federal Court of Appeal[848].

Commentary

This case is interesting because at its core is the relationship between Articles 9(1) and 24(4) OECD MC[849]. Generally, that issue is irrelevant in practice, because the result under both provisions would be the same for the taxpayer: either he argues that the domestic rules are not in accordance with the standards of Article 9(1), or he argues that the domestic rules are not in accordance with the standards of Article 9(1) and that they apply exclusively to non-residents and are therefore contrary to Article 24(4). Here, however, the non-discrimination provision could not be applied because of an express reservation to that effect in the treaty. Consequently, the relationship between Articles 9(1) and 24(4) became a pressing issue. If the matter was governed exclusively by Art. 24(4), the taxpayer's arguments would fail, given the express reservation in the treaty. If Art. 9(1) applied, the taxpayer's argument would succeed.

While I agree with the outcome of the decision, the Court's line of reasoning as regards the relationship between Articles 9(1) and 24(4) is not entirely convincing. The following statement is particularly confusing: *"Absent Article XXV(7), Article IX does not […] preclude a State from limiting the amount of interest a resident of that State may deduct in computing its income because of the ownership of its share capital. […] Article IX(1) permits the States to make adjustments to reflect arm's length transactions. Article IX(1) does not prevent the States from regulating transactions between related persons in the two States who deal with each other on an arm's length basis. Where there is discriminating legislation, Article XXV(7) would apply."*

This seems to imply that Article 9(1) is merely illustrative in nature, which would mean that contracting States are free to apply domestic thin cap rules that go beyond the arm's length standard. Only where they do so in a discriminatory manner, is there a violation of the treaty (i.e. of Art. 24(4)). As pointed out above, however, the OECD correctly favours a restrictive approach, that is to say, that contracting States should not increase the taxable profit of the taxpayer in question to more than the arm's length profit. If they do, they are not acting in accordance with Article 9(1).

---

[848] Federal Court of Appeal 18 May 1999, *Specialty Manufacturing Ltd. v The Queen* (1999) 3 *C.T.C.* 82.
[849] For the sake of clarity, I will refer from here on to the article numbers of the OECD MC instead of the specific numbering of the 1980 Canadian/U.S. treaty.

In my opinion, the taxpayer is correct in arguing that Article 9(1) and 24(4) are two separate provisions dealing with separate situations which, incidentally, both apply to the domestic rule at issue. Article 9(1) applies because the domestic rule does not comply with the arm's length standard, Article 24(4) applies because the rule does not comply with Article 9(1) and because it applies exclusively to payments made to non-residents. In principle, therefore, the taxpayer is free to choose his line of defence. In the present case, however, the non-discrimination provision was made inapplicable by an express reservation in the treaty. But there is no reason why that reservation should affect the application of Art. 9(1).

On the other hand, assuming that the Technical Explanation reflects the treaty partners' intention when signing the treaty, it is clear that the treaty was not intended to preclude the application of the Canadian thin cap rule at issue[850]. It would make no sense if the treaty partners agreed that the non-discrimination provision did not preclude that domestic rule, while at the same time intending that that rule would be set aside by Article 9(1) of the treaty.

In that sense, the judgement is correct: the treaty partners clearly did not want the treaty to set aside the Canadian thin cap rule. In the present case, therefore, neither Article 9(1) nor Article 24(4) could set aside that rule. But that does not imply that, as a general rule, Article 9(1) leaves the contracting States free to apply domestic thin cap rules that go beyond an adjustment to arm's length conditions.

Thus, the general starting point should be that Article 9(1) precludes a contracting State from applying thin cap rules that do not adhere to the arm's length standard. Moreover, if they apply such rules exclusively to payments made to non-residents, there is discrimination contrary to Article 24(4). Generally, however, that violation of Article 24(4) is irrelevant since the conflict with the treaty can be resolved under Article 9(1). Nevertheless, there is a possibility that, due to specific reasons proper to the case at hand, either Article 9(1) or Article 24(4) cannot be applied. In such a case, there is no reason why the taxpayer cannot invoke the other provision – unless, of course, both provisions are inapplicable for the same reason (as was the case here).

F. Article 24(5): foreign ownership

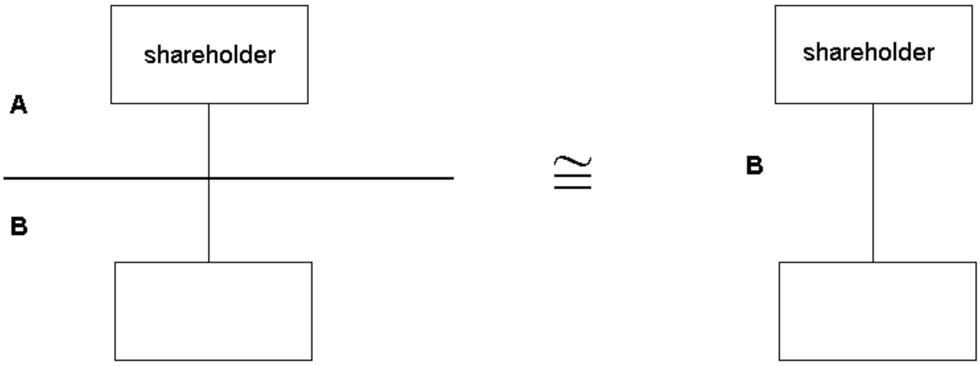
I. Entitlement to Art. 24(5)

I.A. General

a. The wording of Art. 24(5)

Article 24(5) prohibits discrimination on the basis of foreign ownership. According to the terms of the provision, contracting States are prohibited from subjecting enterprises of a contracting State, the capital of which is **wholly or partly owned or controlled**, directly or indirectly, by one or more residents of the other contracting State, to less favourable taxation or connected requirements than to which **other similar enterprises** of the first-mentioned State are or may be subjected[851]. Schematically, this can be represented as follows:

[850] See the statement quoted above: *"Canada may continue to limit the deductions for interest paid to certain nonresidents as provided in section 18(4) of Part 1 of the Income Tax Act"*.
[851] The meaning of the term enterprise was discussed in 2.D.I.



Similarly to Article 24(4), Article 24(5) concerns discrimination between two categories of residents. The subject of comparison is a resident company (or partnership[852]) the capital of which is held by a resident of the other contracting State. The object of comparison is a ‘similar’ resident company (see infra, 2.F.II).

b. Indirect ownership: Re A Oy and B Oy[853]

Two Finnish companies, A Oy and B Oy, were both owned indirectly by a U.S. parent company. The intermediate holding company was established in Bermuda[854]. Finland had a tax treaty with the U.S. but not with Bermuda.

Under Finnish tax law, it was possible to make group contributions between members of a corporate group. Such contributions were deductible for the payer and taxable in the hands of the recipient. To constitute a group for the purposes of that regime, it was necessary that all the companies involved were resident in Finland. Not only the parent company and the subsidiaries had to be residents, intermediate holding companies in the group structure had to meet that condition as well even if they did not play an active part in the contribution.

In the case at hand, A Oy wanted to make a contribution to B Oy but the Finnish tax authorities refused because neither the ultimate parent company, nor the intermediary holding company were Finnish residents. A Oy argued that this refusal constituted discrimination contrary to the ownership non-discrimination clause of the Finnish/U.S. treaty[855]. The tax authorities argued that there was no discrimination because another ‘similar’ company – that

[852] With respect to partnerships, the general rules as to treaty entitlement apply. Accordingly, the partnership itself must be subject to tax in order to qualify as a resident. If the partnership, being a resident of a contracting State, qualifies for protection under Article 24(5), the prohibition of discrimination only concerns the entity as such, and not the partners resident in the other contracting State. On the other hand, if the partnership is treated as fiscally transparent, it is not liable to tax within the meaning of Article 4(1), with the result that it cannot claim protection under Article 24(5). See also J. AVERY JONES, “The non-discrimination Article in tax treaties: Part 2”, *B.T.R.* 1991, 442-443.
[853] Finnish Supreme Administrative Court 22 June 2004, No. KHO:2004:65, 7 *ITLR* 288.
[854] The group structure was quite complicated: the first Finnish company was owned by X, a Bermudan company, which was owned by Z, another Bermudan company. The other Finnish company was owned by a U.K. company, which was owned by Y, a Bermudan company, which, in turn, was owned by Z. Z was owned by two U.S. subsidiaries of the ultimate U.S. parent company. For the sake of clarity, it is assumed here that both Finnish subsidiaries were owned directly by Z and that Z was owned directly by the ultimate U.S. parent company.
[855] Art. 24(4) of the 1989 treaty, which is identical to Art. 24(5) OECD MC.

is to say, a Finnish resident owned by a Finnish parent company through the intermediary of a Bermudan holding company – was not entitled to the deduction either.

The Supreme Administrative Court held in favour of the taxpayer. According to the Court, there was nothing to suggest that the contracting States did not want the ownership non-discrimination clause to apply in a case where the shares in the subsidiary were held indirectly, through an intermediary established in a third State[856].

This case illustrates the importance of the expression *"owned or controlled directly or indirectly"* in Art. 24(5) OECD MC. If the provision only applied to cases of direct ownership, it would not have been applicable in the case at hand. However, because it also applied to cases of indirect ownership, the fact that the intermediary holding company was established in a third country could be disregarded.

That being said, it is essential that the object of comparison remains the same as in cases of direct ownership. In other words, the fact that the ultimate parent company holds the shares through the intermediary of a Bermudan company does not mean that the comparison is with a Finnish resident company, the shares of which are held by a Finnish parent company through the intermediary of a Bermudan company. If that were the appropriate comparison, there would have been no discrimination since the group contribution would not apply in that situation either. Instead, the proper comparison is with a Finnish company with a Finnish direct parent company. There is no reason to treat cases of indirect ownership differently from cases of direct ownership. Whether the subject of comparison is owned directly or indirectly by a resident of the other contracting State, the object of comparison is a resident company that is owned **directly** by another resident company.

> Of course, the fact that the shares in the subject of comparison are held through the intermediary of a Bermudan company may affect the comparability-test if that characteristic is relevant for the domestic measure at issue (see infra). If that is the case, then the object of comparison is a resident company, the shares of which are held by a resident parent company through the intermediary of a Bermudan company. Unfortunately, the Court does not consider whether that characteristic is relevant from the perspective of the Finnish regime at issue.

I.B. Only the resident company is protected

It is essential that the provision only concerns **the taxation of the resident company**, and not that of the persons owning or controlling its capital[857]. The objective of Article 24(5) is not to protect the (non-resident) shareholders or partners of the resident company from

[856] The Court mentions in this respect that the wording of the non-discrimination provision in the Finnish/U.S. treaty differs slightly from that in the OECD MC. However, it does not seem that this difference should have an impact on the outcome of the decision since only the Finnish official version of the treaty differed from the OECD MC. The official English versions of Art. 24(4) of the treaty and Art. 24(5) OECD MC are identical; see L. HINTSANEN and P. VIITANEN, "Supreme Administrative Court ruling on the Finland – US tax treaty non-discrimination clause", *European Taxation* 2004, 462.

[857] The expression *"the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other contracting State"* refers to a myriad of situations (individual shareholder, parent company, etc.). For the sake of simplicity, I will refer to the non-resident who owns or controls the capital as 'the shareholder'. Additionally, instead of referring to 'an enterprise the capital of which is owned or controlled by residents of the other contracting State', I will simply refer to 'the company'.

discrimination as compared to resident shareholders or partners[858]. Consequently, the provision does not prohibit the contracting State in question from taxing the income accruing to the shareholders or partners from their shareholdings differently from such income accruing to residents[859]. For instance, subjecting dividends paid to non-resident shareholders to a flat withholding tax while dividends paid to resident shareholders are included in their overall income and taxed at progressive rates does not fall foul of Article 24(5) since such a distinction does not concern the taxation of the distributing company but that of its shareholders[860].

a. Example: imputation systems vs split-rate systems

Since Art. 24(5) only protects the resident company, imputation mechanisms in corporate tax systems do not come within the scope of the provision because they concern the taxation of the shareholder and not that of the distributing company[861].

Clearly, the situation is different for a split-rate system. Under such a system, different rates of corporate income tax are levied on retained and distributed profits: the higher rate is charged on profits retained and the lower rate on those distributed. Since a split-rate system concerns the taxation of the distributing company, Article 24(5) would be infringed if the lower rate is not extended to distributions made to non-residents. Yet, it could be argued that an imputation system has the same effect as a split-rate system. The idea behind this argument is that a portion of the tax paid by the distributing company is credited to the shareholders, with the result that the actual amount of corporate tax is the net amount after granting the credit[862]. The overall effect of such a regime is to lower the taxes due on distributed income,

---

[858] Comm. OECD on Art. 24, para. 76.

[859] E.g. Tribunal Administratif de Luxembourg 5 April 2000, No. 10473: *"La disposition sous analyse ne protège d'une discrimination dans l'imposition de façon expresse que l'entreprise elle-même et non pas les personnes qui la contrôlent. […] Il résulte de ces éléments que l'article 24 § 6 de la convention prohibe en l'espèce une imposition de la société demanderesse, contrôlée partiellement par un résident belge, divergeant de celle d'une société similaire détenue par des seuls résidents luxembourgeois, dont notamment un régime différent d'imposition dans le chef de la société demanderesse des plus-values latentes inhérentes aux biens transmis. L'imposition personnelle de l'associé de la société demanderesse du chef des plus-values inhérentes à sa participation et faisant partie de son patrimoine personnel reste par contre hors du champ de l'article 24 § 6 de la convention."*

[860] Comm. OECD on Art. 24, para. 78.

[861] K. VOGEL, *o.c.*, 1330-1331.

[862] Being designed to mitigate double taxation upon distribution of profits to the ultimate individual shareholders, imputation systems are traditionally neutral as regards dividends paid between companies (i.e. either the subsidiary's corporate tax liability is shifted to the parent upon distribution or the subsidiary pays the full tax, after which the dividend is tax-free in the hands of the parent). Consequently, if a distinction is made in this respect between dividends paid to resident companies and dividends paid to non-resident companies, that is the result of the fact that the non-resident recipient is not subject to the tax upon re-distribution. For that reason, the present discussion is limited to dividend payments made to individual shareholders. See Comm. OECD on Art. 24, para. 78: *"[Art. 24(5) does not apply] where a State that levies a tax on resident companies that make distributions to their shareholders regardless of whether or not they are residents or non-residents, but which, in order to avoid a multiple application of that tax, would not apply it to distributions made to related resident companies that are themselves subject to the tax upon their own distributions. The fact that the latter exemption would not apply to distributions to non-resident companies should not be considered to violate paragraph 5. In that case, it is not because the capital of the resident company is owned or controlled by non-residents that it is treated differently; it is because it makes distributions to companies that, under the provisions of the treaty, cannot be subjected to the same tax when they re-distribute the dividends received from that resident company. In this example, all resident companies are treated the same way regardless of who owns or controls their capital and the different treatment is restricted to cases where distributions are made in circumstances where the distribution tax could be avoided."* See also the 2005 OECD report on National Treatment for Foreign-

which could be seen as equivalent to the distributing company paying a lower rate of tax on distributed profits under a split-rate system[863].

> Consider the following example. A State has a corporate tax rate of 50% and a personal tax rate of 40%. There is no split-rate system, nor an imputation mechanism, with the result that double taxation on dividends is not mitigated. A company established in that State earns 1,000, which results in an after-tax profit of 500. If that company distributed its entire after-tax profit of 500 to its shareholder, the latter would pay 200 tax on the dividend received. The end result is that the shareholder receives a net dividend of 300, while the company retains none of its earnings.
>
> If the State would apply an imputation system, the net dividend received by the shareholder would increase. Assume that the State grants an imputation credit of 50% of the tax paid by the distributing company. If the company were to distribute a dividend of 500, as above, that would result in a credit of 250. Upon distribution of the dividend, the income received by the shareholder (500) is grossed up by the amount of the credit (250), resulting in a taxable amount of 750. The tax due on that amount (300) is then reduced by the amount of the credit (250), resulting in a net tax of 50. Accordingly, the end result is that the shareholder receives a net dividend of 450, while the company retains none of its earnings. In other words, the net dividend received by the shareholder has increased by 50% as compared to the example where no imputation system applied.
>
> This makes it possible to shift the benefit of the imputation from the shareholder to the distributing company. More specifically, the distributing company can decrease the amount of dividends distributed so as to ensure that the shareholder still has the same net dividend as under the system without imputation, while still retaining a portion of its profits. In particular, if the company woud distribute an amount of 333.33 (instead of 500), the shareholder would end up with a net dividend of 300[864]. For the shareholder, that is the same end result as under the system without imputation. The company, however, would then have retained 166.67 of its earnings. In contrast, the company would not have retained any of those earnings under the system without imputation (see supra).
>
> Now consider the situation where the State in question has a split-rate system with a 50% corporate tax on retained profits and a 25% tax on distributed profits. The company could then reach the same result as described above, i.e. retaining 166,67 of corporate profits while ensuring that the shareholder receives a net dividend of 300. In order to do so, it would have to retain 333,33 of its profit, while distributing the remaining 666.67 to its shareholder. The result would be retained after-tax earnings of 166.67 (i.e. 50% of 333.33) and a dividend of

---

Controlled Enterprises, a non-binding instrument which seeks to ensure that foreign-controlled companies are not treated less favourably than domestic enterprises in similar situations in a number of fields, including taxation. In that report, the imputation issue is briefly addressed as follows: *"The OECD's Committee on Fiscal Affairs considered this problem but has not concluded whether the non-payment of such tax credits to non-resident shareholders, especially parent companies, constitutes discrimination. Imputation systems operate at the level of the ultimate shareholder whereas companies are taxed alike. On the other hand, the denial of tax refunds to foreign parent companies could expose an international group of affiliated enterprises to a higher tax burden as compared to domestic groups and therefore might prove an impediment for the operations of foreign-controlled enterprises. […] It is difficult to give a clear-cut answer applicable in all circumstances. Everything considered, the problem should be left to bilateral negotiations, where the advantages and disadvantages can best be evaluated"* (p. 115 of the report).

863 P. KAPLAN, "European discrimination and American retaliation", *B.T.R.* 1978, 213.

864 The company still pays 500 of corporate tax on its earnings of 1,000. Upon distribution of 333,33, the shareholder is entitled to a credit of 166,67. Consequently, the taxable amount for the shareholder is 500. The gross tax of 200 (i.e. 40% of 500) is then reduced by the credit of 166,67, resulting in a net tax of 33,33. Thus, the end result for the shareholder is 300 (i.e. 333,33 dividend received – 33,33 tax).

500 (i.e. after deducting the 25% tax from the gross distribution of 666.67). After application of the 40% individual income tax, the shareholder ends up with a net dividend of 300.

This feature is even clearer where the imputation system provides for a refund if the credit granted exceeds the shareholder's tax liability. In such a case, the mechanism described here would also work in cases where the shareholder is subject to a low tax rate. For instance, if the shareholder is subject to a tax rate of 15% instead of 40%, the example would be as follows. First, if there was no mechanism to mitigate double taxation, and the company would distribute its entire profit of 500, the shareholder would end up with a net dividend of 425 (500 – 15% tax). In case an imputation system without refund applied, and the company would distribute 333.33 of its profits while retaining 166.67, it would not reach that same result. Indeed, the taxable basis of the shareholder is still 500[865], but the tax calculated (at the rate of 15%) is now only 75, with the result that the credit of 166.67 cannot be entirely offset. The end result is that the shareholder is not liable to tax on the dividend received, but he is not entitled to a refund either, which means that he earns a net dividend of 333.33.

In contrast, if the imputation system provided for a refund, the excess credit of 91.67 would be refunded to the shareholder, who would thus ultimately enjoy a net dividend of 425. That amount is equal to the amount earned under the system without imputation, but now the distributing company also retains 166.67 of its profits. Similarly, if a split-rate system applies and the company distributes 666.67 of its profits while retaining 333.33, the same result would be achieved: the company retains after-tax profits of 166.67, while the shareholder ends up with a net dividend of 425[866].

For those reasons, one could argue that a national imputation system which is restricted to dividends distributed to resident shareholders is equally discriminatory as a split-rate system which is restricted to dividends distributed to resident shareholders.

While it cannot be denied that an imputation system as it is described here produces the same overall after-tax result for the distributing company as a split-rate system, it should be kept in mind that an increase in after-tax earnings is not the same as a decrease in the tax burden. And the purpose of Article 24(5) is not to ensure non-discriminatory treatment as regards retained earnings, but merely non-discriminatory tax treatment. The fact that an overall comparison – i.e. at the company level and the shareholder level combined – reveals that the imputation system is more beneficial than the system without imputation is irrelevant in that regard. Indeed, Art. 24(5) only concerns the treatment at the level of the distributing company. From that perspective – i.e. disregarding the tax treatment at the level of the shareholders – there is no discrimination between the imputation system and the system without imputation. Indeed, the tax position of the distributing company, considered in isolation, is not affected by the application of the imputation mechanism.

The same reasoning applies if the imputation system provides for a refund in the situation where the credit exceeds the tax liability of the shareholder. In that case as well, the refund benefits the individual shareholder, and not the company making the distributing, with the result that its effect is only revealed when an overall comparison is made, taking into account both the company level and the shareholder level. But Article 24(5) calls for a more restricted comparison, i.e. a comparison at the level of the distributing company, without considering the effects at the shareholder level.

[865] I.e. 333,33 dividend received, grossed up by the credit of 166,67, see supra.
[866] (666.67 – 25% tax upon distribution) – 15% individual income tax = 425.

b. Group treatment

Since Art. 24(5) only concerns the foreign-owned resident company, it does not apply to domestic rules that grant tax benefits to a group of companies as a whole. Consequently, Art. 24(5) will often be inapplicable to a ‘group treatment’ regime, i.e. domestic tax rules under which a group of companies is broadly assimilated (to a greater or lesser extent) to a single company for tax purposes. For instance, if a contracting State allows resident companies to consolidate their income with their resident parent companies, the provision does not require that State to allow such consolidation where the parent is a resident of the other contracting State. Doing so would require a comparison of the **combined** treatment of a resident company and its non-resident parent with that of a resident company and its resident parent. As Art. 24(5) is strictly limited to the taxation of the subsidiary, such a ‘combined’ approach clearly goes beyond the scope of the provision.

This is also stressed in the Commentary, where the following examples are given: rules that allow consolidation, transfer of losses or tax-free transfer of property between companies under common ownership[867]. In my opinion, however, those rules will not always fall outside the scope of the ownership non-discrimination clause[868]. Indeed, Art. 24(5) should be applied where (1) a tax benefit is granted to resident companies and (2) that benefit is denied if that resident company is owned or controlled by a non-resident. Art. 24(5) is only inapplicable if one of those conditions is not met. That is to say, the provision can only be disregarded where the tax benefit granted under the domestic rules is not a benefit for the subject of comparison but solely for the group as a whole (e.g. consolidation rules in certain cases; see the next paragraph) or where the distinction is not solely based on the residence of the parent company (but also, for instance, because other companies of the group are non-residents; see 2.F.I.C).

> Even though consolidation rules clearly concern the group as a whole, it is possible that one of the companies involved nevertheless derives an individual benefit from those rules. Consider, for instance, two resident companies with a common non-resident parent company. One of the resident companies has a loss of 100, while the other has a profit of 100. The profit-making company would thus benefit from the consolidation regime, in that it would result in its tax burden being neutralized. Consequently, if the consolidation regime is not applied because the parent company is a non-resident, there is less favourable taxation at the level of the profit-making resident company, contrary to Art. 24(5).
>
> Of course, if it is accepted that Art. 24(5) requires the consolidation regime to be extended to a group with non-resident companies, other limitations on the States’ taxing powers should be taken into account as well. That is to say, the international law principle of territoriality (as expressed in Art. 7 of the treaty with respect to profits) will generally oppose the taking into account of the results of a non-resident member of the group. For instance, Art. 24(5) might theoretically require the subsidiary’s State of residence to allow consolidation with the non-resident parent, but Art. 7 of the treaty precludes that State from taking account of the parent company’s results[869]. Consequently, this line of reasoning only applies to the extent that the distributive rules of the treaty do not preclude the ‘consolidating’ contracting State from taking account of the results of another member of the group. For instance, when the

[867] Comm. OECD on Art. 24, para. 77.

[868] See also G. BOULOGNE, “Een Papillon fiscale eenheid met derde landen? Art. 24, vijfde lid OESO-Modelverdrag biedt uitkomst!”, *WFR* 2010, No. 6876, 1262; G. BOULOGNE, “Group taxation within the European Union: did Papillon and Art. 24(5) of the OECD Model Tax Convention create a butterfly effect?”, *European Taxation* 2011, 176.

[869] See also K. VAN RAAD, “Non-discrimination under tax treaties regarding groups of companies”, in G. MAISTO (ed.), *International and EC tax aspects of groups of companies*, Amsterdam, IBFD, 2008, 160-161.

> consolidation concerns ‘sister’ resident companies with a common non-resident partner (as in the example given above), there is nothing to preclude the consolidating State from taking account of the results of the other resident member of the group.
>
> That being said, there may be another difficulty in applying the ownership non-discrimination provision to such consolidation rules. In particular, in order for Art. 24(5) to apply, the measure at issue must distinguish on the basis of the shareholder’s non-residence. In the example given above, the consolidation is not excluded solely because the profit-making company is owned by a non-resident but also because the loss-making company is owned by a non-resident[870]. That point will be addressed in 2.F.I.C.

As an example, consider the Swedish group contribution regime, which will be discussed in 2.F.I.C and in 2.F.III.B.c. By treating intra-group transfers as deductible expenses for the transferor and as taxable income for the transferee, that regime aimed to achieve tax equalization, that is to say, its purpose was to prevent the tax burden borne by a business carried on by a group of companies from being greater than if it was carried on by a single company. Consequently, the regime granted a benefit to groups of companies as a whole. However, that does not mean that Art. 24(5) cannot be applied. In particular, when the transferee is considered in isolation, the deductibility of the payment constitutes a tax benefit as well. Consequently, if the deductibility is denied solely because the transferee is owned or controlled by a non-resident, there is discrimination contrary to Art. 24(5). The mere fact that the discriminatory measure (i.e. non-deductibility if the transferee is foreign-owned) forms part of a regime that is concerned with the taxation of a group of companies as a whole does not detract from that conclusion[871]. As repeatedly stressed earlier, Art. 24 OECD MC requires the domestic measure at issue to be considered in isolation.

[870] In his observations of 3 July 2007 on the OECD Public Discussion Draft of 3 May 2007 on the Application and Interpretation of Article 24, R. BERGER also argues that Art. 24(5) may require group consolidation rules to be extended to resident sister companies. However, he side-steps the difficulty described here (i.e. the fact that the consolidation is not excluded solely because the profit-making company is owned by a non-resident but also because the loss-making company is owned by a non-resident) by pointing out that Art. 24(5) expressly refers to “enterprises” in the plural, which implies that the provision applies to the two resident sister companies together. I disagree with that argument. There is nothing in the Commentary, nor in the history of the provision that suggests that the plural form has been used in order to expand the scope of the provision. Moreover, Art. 24(1) and 24(2) also refer to the subject of comparison in the plural (i.e. “nationals” and “stateless persons”), without that plural form having any specific meaning.

[871] For another example, see BFH 9 February 2011, *I R* 54/10, which concerns the impossibility for the U.K. parent of a German company to be a fiscal unity parent for trade tax purposes. C-GmbH, a German company, paid interest to X, its German parent company. X’s sole shareholder was C plc, a U.K. company. The interest was not deductible for purposes of the German trade tax. Conversely, interest paid between members of an Organschaft was deductible. Only ‘domestic business enterprises’ could be a fiscal unity parent for trade tax purposes. Consequently, if the U.K. company had been a German resident, it could have formed an Organschaft with the two German companies, in which case the interest would have been deductible. The BFH held that this distinction violated the ownership non-discrimination provision of the 1964 German/U.K. treaty (identical to Art. 24(5) OECD MC). It is important that the taxpayer was not asking for the Organschaft regime to be applied, but only arguing that the non-deductibility of the interest was discriminatory because it would have been deductible if the U.K. company had been a German resident. By deciding in favour of the taxpayer, the BFH confirms here that a disadvantage incurred by a foreign-owned enterprise infringes Art. 24(5) even if it results from the inapplicability of a domestic group regime such as the Organschaft. But that does not necessarily mean that the U.K. company should qualify as fiscal unity parent: the BFH only says that the interest should be deductible. On the other hand, the BFH also seems to consider that the interest should be attributed to the U.K. parent (as the fiscal unity parent). The fact that the income might then not be taxable in Germany in the absence of a German PE does not detract from this conclusion. The BFH acknowledges that its solution may lead to undertaxation (if the foreign fiscal unity parent is not taxed on the income), but it considers that this is due to the national laws of the other contracting State and the division of taxing powers between Germany and that other State. According to the BFH, it cannot be inferred from the text of the treaty that group taxation regimes and

As a result, this aspect of the Commentary on Art. 24(5) should be nuanced. It is correct that the provision only concerns the taxation of the resident enterprise (i.e. the subject of comparison) and not of the persons owning or controlling the capital, but that does not mean that *"it cannot be interpreted to extend the benefits of rules that take account of the relationship between a resident enterprise and other resident enterprises (e.g. rules that allow consolidation, transfer of losses or tax-free transfer of property between companies under common ownership)"*. Such rules also concern the taxation of the subject of comparison and do not relate solely to the taxation of the owners[872]. Therefore, they should not be excluded from the scope of Art. 24(5) beforehand. Domestic rules only fall outside the scope of that provision if the conditions for its application are not met (i.e. if (1) it does not concern a benefit for the resident enterprise rather than for the group as a whole or (2) the distinction is not based on foreign ownership). And that assessment should be made in each case individually, without excluding beforehand categories of rules merely because they serve to take account of the group of companies as a whole[873].

I.C. Discrimination on the basis of foreign ownership

a. On the basis of

Art. 24(5) protects residents that are owned or controlled by residents of the other contracting State from discrimination as compared to residents that are owned or controlled by residents of their home State. From the text of the provision, it is not clear whether it guarantees a certain standard of treatment to all taxpayers falling within a specific category or whether it seeks to prohibit a specific type of discrimination. That is to say, the text of Art. 24(5) could be interpreted as not requiring the distinction to be made **on the basis of** foreign ownership. Under that interpretation, the provision should apply if a company owned or controlled by non-residents is taxed less favourably than a company controlled by residents, regardless of whether the distinction is made on the basis of foreign ownership or on the basis of some other criterion[874]. In other words, as soon as a resident taxpayer is owned or controlled by non-residents, it must not be treated less favourably than resident taxpayers owned or controlled by residents.

A more restrictive interpretation would be that Art. 24(5) only applies if the distinction at issue is made **on the basis of** foreign ownership. Under that interpretation, the provision does not apply when there is no connection between the discrimination and the foreign ownership[875]. In other words, the provision does not seek to ensure that all foreign-owned residents receive a certain standard of treatment. Instead, it merely curbs a specific type of discrimination, namely discrimination on the basis of foreign ownership.

---

consolidation regimes should be *a priori* excluded from Art. 24(5), simply because of the various associated tax advantages and disadvantages at the various levels of the group. Even if the result would be double non-taxation of the income, that could not justify the discrimination (see para. 21 of the decision). For a similar issue, see also the *Delaware* case, discussed in 2.F.III.B.a.

[872] This point was also made by the First-Tier Tribunal in *FCE Bank*, para. 30 (see 2.F.II.D.h).

[873] The same conclusion is reached by J. AVERY JONES, e.a., "Art. 24(5) of the OECD Model in relation to intra-group transfers of assets and profits and losses", *World Tax Journal* 2011, 179-225.

[874] E.g. B. CLEAVE, "Boake Allen Ltd and others v HMRC – group income elections and non-discrimination", *B.T.R.* 2007, 606.

[875] E.g. K. VOGEL, *o.c.*, 1331, No. 165.

The Commentary takes the latter approach and notes that the distinction at issue must be made on the basis of the resident company's foreign ownership or control[876]. When other distinguishing criteria are used, there is no discrimination contrary to Article 24(5), even if those criteria indirectly affect foreign-owned or foreign-controlled companies. For instance, a tax measure targeting a business sector in which mainly foreign-owned or foreign-controlled companies operate cannot be said to infringe Article 24(5), since the distinction is not made on the basis of foreign ownership or control. So there are two cumulative conditions that must be met before a domestic rule can be said to infinge Art. 24(5): the distinction at issue must be based on the fact that a resident taxpayer is (1) owned or controlled (2) by a non-resident. The combination of those two factors must be the reason for the distinction.

While it is true that Art. 24(5) has a very specific purpose and should therefore be given a restrictive interpretation, it should be stressed that the provision must be interpreted in accordance with the principle of non-discrimination, of which it is an expression. That is to say, Art. 24(5) should not be seen as a mere prohibition of one specific type of distinction. Instead, it seeks to protect a certain category of taxpayers from being treated less favourably as compared to another, comparable category of taxpayers. That is to say, the subject of comparison should not be treated less favourably than the object of comparison, it being understood that **all relevant characteristics** (apart from foreign ownership) are identical among subject and object of comparison. This will be addressed in 2.F.I.C.c.

b. On the sole basis of?

There is an additional issue that needs to be addressed here. It is possible that a distinction is based not only on foreign ownership, **but also** on some other factor. For instance, suppose that a tax benefit is granted to all domestically-owned residents and to foreign-owned residents on the condition that the shares in the latter are held by a PE in the State in question. The distinction is then not based solely on foreign ownership **but also** on the fact that the foreign owner does not have a PE in the State of its subsidiary. The question arises whether Art. 24(5) can be applied to such a rule.

Since the 2008 update, the Commentary states that Art. 24(5) *"prevents the discrimination of a resident enterprise that is* ***solely based on who owns or controls the capital*** *of that enterprise"*[877]. This could be interpreted as meaning that the provision is not intended to apply if the discrimination is not only made on the basis of foreign ownership, but also on another basis (see the example given above). In such a situation, the discrimination is not **solely** on the basis of foreign ownership (i.e. not on the **sole** basis of foreign ownership).

---

[876] See Comm. OECD on Art. 24, para. 78, where it is noted that withholding obligations imposed on payments made to non-resident shareholders and not on payments made to resident shareholders do not violate Art. 24(5) because *"in that case, the different treatment is not dependent on the fact that the capital of the company is owned or controlled by non-residents but, rather, on the fact that dividends paid to non-residents are taxed differently"*.

[877] Comm. OECD on Art. 24, para. 79 (emphasis added). See also Comm. OECD on Art. 24, para. 3, which, since the 2008 update, states: *"The various provisions of Article 24 prevent differences in tax treatment that are* ***solely*** *based on certain specific grounds (e.g. nationality, in the case of paragraph 1). Thus, for these paragraphs to apply, other relevant aspects must be the same. The various provisions of Article 24 use different wording to achieve that result (e.g. 'in the same circumstances' in paragraphs 1 and 2; 'carrying on the same activities' in paragraph 3;* ***'similar enterprises' in paragraph 5)****"* (emphasis added). A similar point is made with respect to Art. 24(1) in Comm. OECD on Art. 24, para. 8: *"the underlying question is whether two persons who are residents of the same State are being treated differently* ***solely*** *by reason of having a different nationality"* (emphasis added).

However, it is submitted that such an interpretation is overly restrictive. Consider, for instance, a rule that prohibits State A from discriminating against State B nationals. If State A enacts a measure that discriminates specifically against female State B nationals, it still discriminates against State B nationals. Deciding otherwise would seriously undermine the value of the non-discrimination rule. Since that rule prohibits a State from distinguishing on the basis of a given prohibited criterion, it is irrelevant that another criterion is used at the same time: the prohibition of discrimination on the basis of that prohibited criterion is still infringed[878].

Therefore, it seems that the term 'solely' as it is used in the Commentary serves a different purpose. In particular, it stresses that Art. 24(5) is **only** concerned with discrimination on the basis of foreign ownership. When, instead of foreign ownership, another criterion is used, there is no discrimination. That is to say, there is no discrimination when the prohibited criterion is present, but is not the cause of the distinction (see supra). Clearly, that is not the same as requiring foreign ownership to be the **sole** distinguishing criterion (which would mean that there must not be other, **additional** distinguishing factors). In other words, the term 'solely' does not require foreign ownership to be the sole distinguishing criterion; it merely stresses that Art. 24(5) only applies if there is a necessary link between foreign ownership and the distinction at issue[879]. How this can be determined will be addressed hereafter.

c. Application of these principles

All of this may seem quite straightforward, but the practical application of these principles can give rise to some intricate complexities. Consider, for instance, a domestic rule on group reliefs that applies only if the resident subsidiary is owned by a resident corporation[880]. In such a case, it could be argued that Art. 24(5) has not been infringed because the domestic rules do not allow for the application of the regime in any situation where a non-corporate shareholder owns the resident subsidiary, regardless of whether that shareholder is a resident or a non-resident. Accordingly, since the distinction is not based on the shareholder's non-residence, but on the shareholder's non-corporate status, there is no discrimination[881].

---

[878] See, for instance, the *Delaware* case (discussed in 2.F.III.B.a). That case concerned the German fiscal unity regime, under which a company could qualify as an 'Organträger' (fiscal unity parent) if it was a German resident **or** if it was a non-resident with a PE in Germany. In other words, the benefit was denied if the parent company in question was a non-resident **and** did not have a PE in Germany. So it could be argued that the distinction was not on the **sole** basis of the parent company's non-residence with the result that the measure at issue does not infringe Art. 24(5). As argued here, however, that would be an overly restrictive interpretation of Art. 24(5). That provision is intended to cover situations where the distinction is made on the basis of foreign ownership, regardless of whether another criterion is also present. Of course, it is possible that that other criterion should be taken into consideration in the comparability-test, in order to ascertain whether the situations at hand are comparable or not. In the *Delaware* case, however, that was irrelevant since the subject of comparison was the resident subsidiary of a non-resident parent, the latter not having a PE in Germany, while the object of comparison was the resident subsidiary of a resident parent.

[879] Similarly: J. AVERY JONES, e.a., "Art. 24(5) of the OECD Model in relation to intra-group transfers of assets and profits and losses", *World Tax Journal* 2011, 224.

[880] As pointed out above, group relief rules may go beyond the scope of Art. 24(5). In particular, where the rules do not benefit the subsidiary individually but only the group as a whole, the ownership non-discrimination provision cannot be applied since the non-application of those rules would not lead to less favourable taxation of the subject of comparison. For the purposes of the example given here, it is assumed that the group relief rules benefit the subsidiary individually.

[881] An argument which is used, for instance, in the context of the U.S. regime on consolidated returns by P. GLICKLICH and S. GOLDBERG, "United States", in IFA, *Cahiers de droit fiscal international. Non-discrimination rules in international taxation*, Vol. 78b, Deventer, Kluwer, 1993, 730.

However, Art. 24(5) requires the subject of comparison to be compared with a **similar** resident company (see hereafter). It could be argued that ‘similar’ implies that all relevant factors, apart from the shareholder’s residence, must be the same. Therefore, it might be necessary to take the characteristics of the shareholder into account when constructing the object of comparison, insofar as those characteristics are relevant for the purposes of the comparison. In the case at hand, that would mean that a resident company owned or controlled by a non-resident individual must be compared to a resident company owned or controlled by a resident individual. Since the latter is not entitled to the domestic rules on group relief, the former cannot claim entitlement to that regime on the basis of Art. 24(5). As neither subject nor object of comparison are entitled to the benefit, there is no discrimination. On the other hand, if the subject of comparison is a resident company owned or controlled by a non-resident corporation, it should be compared with a resident company owned or controlled by a resident corporation. Since the latter is entitled to the consolidation regime while the former is not, the domestic rules constitute an infringement of Art. 24(5)[882].

Consequently, the statement in the Commentary that the distinction must be based solely on foreign ownership does not mean that Art. 24(5) is inapplicable as soon as there is a distinguishing criterion other than foreign ownership. Otherwise, the provision would be rendered ineffective, in that it could not be applied in any situation where some irrelevant distinguishing criterion is used, instead of foreign ownership. Rather, the provision seeks to prevent that foreign-owned companies are treated less favourably than similar domestically-owned companies, similar being understood as *“all relevant characteristics apart from the shareholder’s residence being identical”*. Accordingly, it is not sufficient to simply ascertain whether the domestic rule formally distinguishes on the basis of foreign ownership. Otherwise, it would be irrelevant whether the subject and object of comparison are comparable (i.e. similar), since the provision would be strictly limited to prohibiting contracting States from making a specific type of distinction. Such an interpretation is too narrow and it does not do justice to the analysis underlying the concept of non-discrimination.

It is therefore essential that the subject and object of comparison are constructed before the remainder of the discrimination-analysis is carried out. In other words, the correct approach in applying Art. 24(5) is first to determine the subject of comparison and then construct an appropriate object of comparison, that is to say, a **similar** resident company the capital of which is owned or controlled by a resident. Finally, one should verify whether the subject of comparison is treated less favourably than the object of comparison, even though they are identical in all relevant respects apart from the residence of the shareholder. If that is the case, there is discrimination contrary to Art. 24(5) because it can be said that the distinction is made on the basis of the shareholder’s non-residence.

To summarize, the application of a non-discrimination rule that prohibits discrimination on a given basis, such as Art. 24(5)[883], can be approached in two ways. The first approach consists of determining whether the distinction is made on the basis of the prohibited criterion. In order to do so, it is necessary to verify whether there are situations where the benefit at issue is denied even though the prohibited criterion is not present. Consider, for instance, a domestic measure that only grants a tax benefit to resident companies if their shareholders are

[882] See also R. PAPOTTI, “Treaty non-discrimination clauses in group consolidation situations”, *Intertax* 2003, 322.

[883] As opposed to a non-discrimination rule that guarantees that the subject of comparison is entitled to a treatment that is not less favourable than the treatment accorded to the object of comparison, regardless of whether the distinction is made on the basis of a specific criterion.

liable to a specific domestic tax. In order to determine whether that distinction infringes Art. 24(5), it is necessary under the first approach to find situations where the benefit in question is denied even though the shareholder is a resident[884]. If that is the case, the distinction is not based on foreign ownership but on some other criterion.

Under the second approach, it is necessary to first construct the subject and object of comparison by defining all relevant characteristics, apart from the prohibited criterion. If the result of that analysis is that the subject of comparison is treated less favourably than the object of comparison, even though both are comparable, there is discrimination contrary to Art. 24(5).

Even though both approaches lead to the same result, the second approach is preferable to the first. As a result of the strict analytical framework of the second approach, it is easier to apply in practice, particularly in complex situations where it is unclear whether the distinction is made on the basis of the prohibited criterion and, if not, whether the criterion that is used nevertheless coincides with the prohibited criterion. In such situations, it is difficult to imagine all the possible hypothetical situations in which the benefit would be granted or would not granted. Moreover, the second approach is a better expression of the principle underlying the discrimination-test of Art. 24. That provision is intended to ensure that a protected category of taxpayers is not treated less favourably than another category of taxpayers, insofar as they are comparable. As a result of its narrow analysis, the first approach creates the risk that the importance of the comparability-test will be understated.

d. Example: the Swedish Supreme Administrative Court on the interpretation of 'solely'

1. The Court's decision

In 1993, the Swedish Supreme Administrative Court decided an interesting case that illustrates the importance of these issues[885]. The case concerned the Swedish 'group contribution' regime which governed intra-group transfers. Under that regime, transfers between companies of the same group were treated as deductible expenses for the transferring company and as taxable income for the transferee (who could, for instance, set off losses against that income). The purpose of the regime was to achieve tax equalization, i.e. to prevent the tax burden borne by a business carried on by a group of companies from being greater than if it was carried on by a single company[886].

In order for the intra-group transfer regime to apply, both the transferring company and the transferee had to be Swedish residents. Moreover, the parent company of the group, as well as

[884] It is not sufficient to find a situation where the benefit is **granted**, even though the shareholder is a non-resident. Finding such a situation does not warrant the conclusion that the distinction is not based on foreign ownership. Take, for instance, a domestic rule that grants tax benefits to resident companies if their shareholders are residents **or** if their shareholders are non-residents with a PE in that State. So the benefit is denied if the shareholder is a non-resident **and** if that non-resident does not have a PE in the State in question. Clearly, the distinction is made on the basis of foreign ownership. In all the situations where the benefit is denied, the prohibited criterion is present. Admittedly, there is also an additional criterion (namely the shareholder not having a PE) but, as argued above, Art. 24(5) cannot be interpreted as requiring the distinction to be made on the sole basis of foreign ownership.

[885] *RÅ* 1993 ref 91 II, discussed in K. STÅHL, "The application of the treaty non-discrimination principle in Sweden", *Intertax* 2000, 198-199.

[886] See B. WIMAN, "Swedish tax law and discrimination – some observations", *EC Tax Review* 1997/2, 103.

any intermediary company (e.g., where a parent company made a transfer to a sub-subsidiary), had to be resident in Sweden as well[887].

In the case at hand, a German parent company had a German and a Swiss subsidiary, both of which had a Swedish subsidiary. The Swedish sub-subsidiary that was owned by the German subsidiary made a transfer to the Swedish sub-subsidiary that was owned by the Swiss subsidiary. The transferring company was unable to deduct the payment because the parent company of the group and the two intermediary companies were not resident in Sweden:

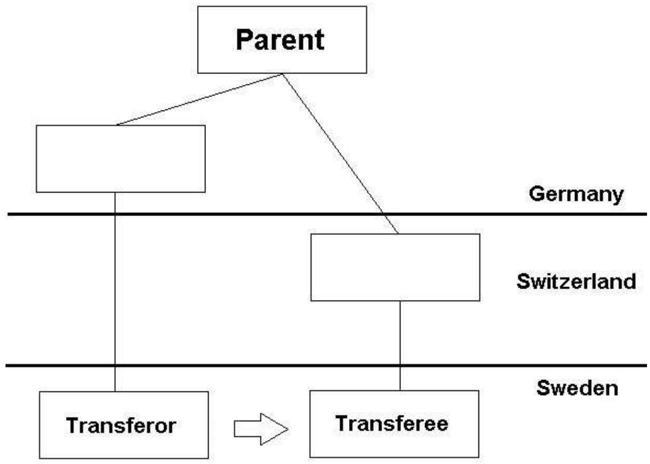


Table 1: Subject of comparison

The question arose whether that refusal constituted discrimination contrary to the ownership non-discrimination provision of the German/Swedish treaty[888].

The Court held that the ownership non-discrimination provision prohibited discrimination that is based **solely** on the fact that the subject of comparison is owned or controlled by residents of the other contracting State. In the present case, that means that there would have to be discrimination solely because the transferring company was owned by a German resident. However, the deduction was denied in the present case not only because the **transferor** was owned by a non-resident, but also because the **transferee** was owned by a non-resident. The Court thus held that allowing the deduction would require a parallel application of the non-discrimination provision of two separate treaties. According to the Court, that was impossible because tax treaties have effect only between the contracting States.

2. Analysis
<u>On the sole basis of?</u>

The Court's decision seems to suggest that Art. 24(5) requires foreign ownership to be the **sole** distinguishing criterion. As discussed above, that interpretation is overly restrictive. Art. 24(5) prohibits a contracting State from making a distinction between a foreign-owned resident and a similar domestically-owned resident on the basis of the former's foreign

[887] This Swedish regime was also analysed by the ECJ in C-200/98, *X AB & Y AB*, which will be discussed in Part III, 2.E.I.A.b.4.b.
[888] Art. 22(4) of the 1959 German/Swedish treaty, which is identical to Art. 24(5) OECD MC. Since the discrimination at issue concerned the inability of the transferring company (which was owned by the German subsidiary) to deduct the payment, the applicable treaty was that with Germany.

ownership. The fact that a distinction is **also** based on another consideration, in addition to foreign ownership (namely the foreign ownership of the transferee in the present case), should not alter the conclusion that the Swedish rule distinguishes on the basis of the subject of comparison's foreign ownership. And that is prohibited, regardless of whether there are other distinguishing criteria present at the same time.

The Court decides that there was no discrimination because the distinction was not made on the **sole** basis of foreign ownership, that is to say, because the deduction was denied not only because the transferor (the subject of comparison) was foreign-owned, **but also** because the transferee was foreign-owned. This implies that the benefit was denied on the basis of two cumulative criteria: that the transferor is owned by a non-resident **and** that the transferee is owned by a non-resident. Worded differently: this argument implies that the deductibility would only be denied if the transferor was owned by a non-resident **and** if, at the same time, the transferee was owned by a non-resident.

But that cannot be what the Court meant, since the distinction made by the Swedish group contribution regime was not based on cumulative criteria[889]. Under the Swedish regime, the deductibility was denied if the transferor was owned by a non-resident **or** if the transferee was owned by a non-resident. Assume, for instance, that the transferee, X, is the Swedish subsidiary of a Swedish parent company. That Swedish parent company also has a non-resident subsidiary which, in turn, has a Swedish subsidiary, Y. If X makes a transfer to Y, the deductibility will be refused. However, it cannot be said that the reason for that refusal is the transferor's foreign ownership, since the transferor is owned by a Swedish resident. Instead, the reason for the refusal is that the transferee is owned by a non-resident. So the two criteria (i.e. the transferor being owned by a non-resident and the transferee being owned by a non-resident) are not cumulative. As soon as one of those criteria is present, the deductibility is refused.

So deciding that there is no discrimination because the Swedish group contribution regime does not distinguish on the sole basis of foreign ownership (as the Court did) creates the impression that the distinguishing criteria used under domestic are cumulative. Clearly, they are not.

This illustrates that the first approach described above (i.e. simply determining whether the distinction is based on foreign ownership) can lead to confusing conclusions. The analysis would be clearer if the second approach were applied (i.e. first constructing the subject and object of comparison and, in case they are comparable, determining whether the former is treated less favourably). In that case, the fact that the distinction was 'also' made on the basis of the foreign ownership of the transferee, comes up for discussion when determining the appropriate object of comparison.

The subject of comparison is described in Table 1. But what is the appropriate object of comparison? The most obvious candidate would be the Swedish subsidiary of a Swedish parent company that makes a transfer to another Swedish subsidiary of that Swedish parent company:

[889] That is to say, the **denial** of the regime was not based on cumulative criteria. Since the conditions that had to be fulfilled for the regime to **apply** were cumulative (see supra), it was sufficient that one condition was not met for the regime to be denied (i.e. not cumulative).

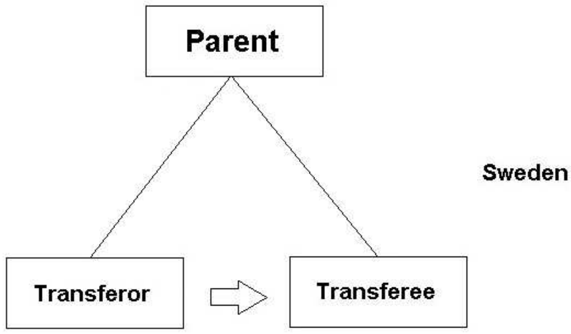


Table 2: Object of comparison 1

If the subject of comparison is comparable to this object of comparison is, there is discrimination since the former is not entitled to the deduction while the latter is. The question thus arises whether the fact that the subject of comparison makes a transfer to a Swiss-owned Swedish resident rather than to a Swedish-owned Swedish resident is a relevant characteristic. If it is not, the subject of comparison is comparable to object of comparison 1, with the result that there is discrimination if the deduction is granted to the latter but not to the former.

On the other hand, if the fact that the subject of comparison makes a transfer to a Swiss-owned Swedish resident rather than to a Swedish-owned Swedish resident is a relevant characteristic, the distinction does not give rise to discrimination since the situations are not comparable.

Instead, the subject of comparison can then only be compared with the following object of comparison:

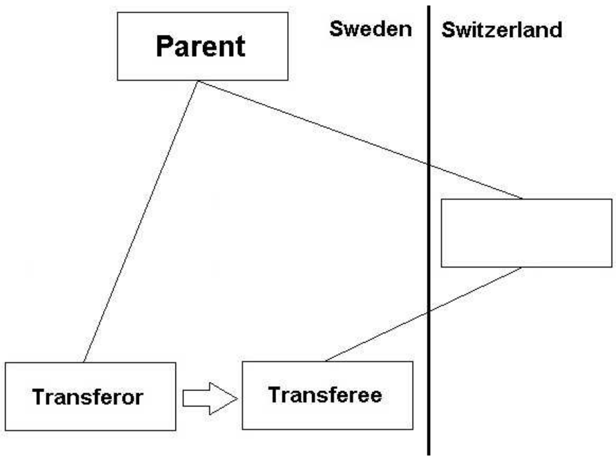


Table 3: Object of comparison 2

In object of comparison 2, all the relevant characteristics (including the non-residence of the transferee's parent company) are identical to those of the subject of comparison, meaning that subject and object of comparison are comparable. Since the transferor in object of comparison 2 is not entitled to the deduction either (the direct parent company of the transferee being a non-resident), there is no discrimination since the subject of comparison is not treated less favourably than the object of comparison.

The decisive question therefore is whether the fact that the subject of comparison makes a transfer to a Swiss-owned Swedish resident rather than to a Swedish-owned Swedish resident is a relevant characteristic. I do not see why the place of residence of the shareholder of the transferee is relevant for the deductibility by the transferor of the transfer. There is no reason why the deductibility should not be applied where the transferee's shareholders is a non-resident. Since the transferee itself is a Swedish resident, it cannot be argued that the deductibility will not be compensated for by a corresponding taxation at the level of the transferee. From that perspective, the place of residence of the **transferee** could be relevant for the deductibility by the transferor, but there is nothing to suggest that the place of residence of the transferee's **shareholders** is relevant[890].

For that reason, it is submitted that the appropriate comparison is with object of comparison 1 and not with object of comparison 2. Since the situations are comparable and the object of comparison is able to deduct the transfer while the subject of comparison is not, there is discrimination contrary to Art. 24(5).

The parallel application of two tax treaties?

An additional point of interest is that the Court states that a 'parallel' application of the non-discrimination provisions of two tax treaties (i.e. the Swedish treaties with Germany and Switzerland) is required in order to allow the deduction. It is not immediately clear why this would be necessary. Perhaps the Court considers that allowing the application of the group contribution regime requires the simultaneous application of both treaties because the distinction was not only based on the fact that the transferor was owned by a German resident, but also on the fact that the transferee was owned by a Swiss resident. In other words, since the denial results in the simultaneous discrimination of both the transferor and the transferee, both tax treaties should be applied simultaneously.

However, it cannot be argued that the non-deductibility constitutes discrimination against the transferee (which would require application of the Swedish/Swiss treaty). The only discrimination arising here concerns the fact that the transferor is unable to deduct the payment. That has nothing to do with any discrimination at the level of the transferee. If I understand the Swedish regime on intra-group transfers correctly, it makes no difference for the transferee whether that regime applies or not.

Assume, for instance, that the transferee has losses that cannot be carried over. If the transfer constitutes taxable income in its hands, it can offset its losses against the transferred profits. Consequently, if the inapplicability of the Swedish regime implies that the transfer is not taxable in the hands of the transferee, its tax position is ultimately left unaffected. The transferee will pay no taxes in the tax year at issue and it will forfeit the losses (which, considered from the perspective of that company in isolation, cannot be considered to

[890] The mere fact that the place of residence of the transferee's shareholder is referred to in the domestic measure at issue (i.e. as a condition for applicability of the group contribution regime) does not mean that it is a relevant characteristic for the purposes of testing the discriminatory nature of that measure. The disadvantage suffered by the subject of comparison (a resident transferor owned by a non-resident) is precisely that an additional condition applies for the group contribution regime to apply, namely that the transferee's shareholder must also be a resident. For that reason, that characteristic in itself is not sufficient to render the situations incomparable (see also Part IV, 2.B.I.A.d, where a similar issue is discussed in the context of the 2006 decision of the Austrian Verwaltungsgerichtshof).

constitute a disadvantage since it could not carry them over to begin with)[891]. Therefore, the actual benefit of the regime is the deductibility at the level of the transferor.

Furthermore, even if the inapplicability of the regime also resulted in a disadvantage for the transferee, the simultaneous application of two tax treaty rules would still not be necessary. Assume that Swedish domestic law provides for a loss carry-over that is limited in time. Then, the transferee would benefit from being able to use its losses immediately. If it is unable to do so, there is a risk that those losses will be forfeited in the future if no sufficient profits are realized before the deadline of the loss carry-over expires. If that were the case, the non-applicability of the group contribution regime could also give rise to a disadvantage for the transferee. However, that would still not mean that applying the non-discrimination rule at the level of the transferor requires the simultaneous application of two tax treaties. What is at stake then, is that both the transferor and the transferee are discriminated against. Both instances of discrimination should be assessed separately. With respect to the transferor, it should be ascertained whether the ownership non-discrimination clause of the German/ Swedish treaty is infringed, i.e. whether the subsidiary of a German parent is treated less favourably than a similar subsidiary of a Swedish resident. With respect to the transferee, it should be ascertained whether the ownership non-discrimination of the Swedish/Swiss treaty is infringed, i.e. whether the subsidiary of the Swiss parent is treated less favourably than a similar subsidiary of a Swedish resident.

II. The comparability-test: ‘other similar enterprises’

The comparison under Article 24(5) is with ‘other similar enterprises’ of the contracting State concerned. A number of treaties deviate from the OECD MC and provide that the object of comparison must be ‘in the same circumstances’[892]. Another deviation from the OECD MC that can sometimes be found in practice is the requirement that the object of comparison is ‘carrying on the same activities’[893].

> As can be seen in I.D, the expression ‘other similar enterprises’ was already used in the 1963 Draft Convention. In contrast, the reports of OECC Working Party no. 4 originally referred to ‘other similar enterprises **in the like circumstances**’, which was later changed to ‘in the same circumstances’. As pointed out in I.C, the expression ‘in the same circumstances’ was deleted in the final report because it could be misleading and because it did not add anything to the meaning of a provision, *“the purpose of which is to subject enterprises situated in a given State and under foreign control to the same treatment as similar enterprises likewise established in the same State”*. It is not clear why this expression was deleted from the ownership non-discrimination clause, but not from the nationality non-discrimination clause (to which it had also been added in the Working Party’s final report). This divergence is

[891] On the other hand, if the transfer is taxed (and can thus be used to offset losses) regardless of whether the regime on intra-group transfers applies, it cannot be said that the transferee incurs a disadvantage as a result of the inapplicability of that regime since the transferee is not treated differently where the regime applies and where it does not apply.

[892] E.g. Article 23(1)(c) of the 1982 Australia/U.S. treaty; Art. 24(4) of the 1985 India/Thailand treaty; Art. 24(4) of the 1987 India/Indonesia treaty. A number of treaties concluded by India use the expression *“in the same circumstances and under the same conditions”* (e.g. Art. 24(5) of the 1993 Belgium/India treaty).

[893] E.g. Art. 24(3) of the 1967 French/U.S. treaty; Art. 24(3) of the 1970 Belgian/U.S. treaty; Art. 23(3) of the 1983 New Zealand/U.K. treaty. See also J. O’BRIEN, “The nondiscrimination article in tax treaties”, *Law and Policy in International Business* 1978, 583, who argues that the expression “similar enterprises” as it is used in Art. 24(5) OECD MC is *“roughly equivalent to the ‘same activities’ test of the permanent establishment paragraph, i.e. relating to the type of industry”*.

unfortunate, particularly considering that the Working Party initially considered that the addition of the expression ‘in the same circumstances’ was *“unnecessary”* (see I.C.II).

That being said, the 2008 update to the Commentary has clarified that these differences in wording have little practical importance: in Comm. OECD on Art. 24, para. 3, it is pointed out that the various paragraphs of Art. 24 all prohibit discrimination that is solely based on certain specific grounds. Consequently, for these paragraphs to apply, all other relevant aspects must be the same. The various paragraphs *“use different wording to achieve that result (e.g. ‘in the same circumstances’ in paragraphs 1 and 2; ‘carrying on the same activities’ in paragraph; ‘similar enterprises’ in paragraph 5)”*. The Commentary thus points out that the absence of the expression ‘in the same circumstances’ from Art. 24(5) does not matter since the function of that expression (i.e. ensuring that all other relevant factors, apart from the comparative attribute, are identical) is already fulfilled by the term ‘similar’.

It is interesting to note that, out of the U.K. treaties that applied at the time (which inspired the text of the non-discrimination provision in the OEEC report), only the treaty with Switzerland used the expression ‘in the same circumstances’[894]. As noted in I.C, it was the Swiss delegation that proposed to include a non-discrimination provision concerning foreign ownership, and the text suggested by that delegation also included the expression ‘in the like circumstances’.

It is important that the ‘similarity’ referred to in Art. 24(5) concerns the two resident companies that are being compared, i.e. the subject of comparison (a resident company owned by residents of the other contracting State) and the object of comparison (i.e. a similar resident company). For that reason, the legal form of the foreign parent should generally not be considered when comparing the subject of comparison to a ‘similar’ resident company[895]. However, the fact that the subject of comparison is **owned or controlled** by another person should generally be taken into account. That is to say, the proper comparison is generally with another resident company that is owned or controlled.

Consider, for instance, the *American Air Liquide*[896] case. The taxpayer was a U.S. resident company with a French parent. The U.S. subsidiary received royalties from its French parent, which had been subject to French source tax. For the purposes of calculating the foreign tax credit in the U.S., different categories of income were placed in different ‘baskets’. The taxpayer placed the royalty income in the ‘general limitation income’ basket. The tax authorities contended that it should have been placed in the ‘passive income’ basket, which resulted in additional tax being due in the U.S.

[894] Article XVIII(3) of the 1954 treaty.

[895] *Contra*: Swedish Supreme Administrative Court, *RÅ* 1996 ref 69, where it was held that the Swedish subsidiary of a German *Kommanditgesellschaft auf Aktien* (KGaA) was ‘similar’ to the Swedish subsidiary of a Swedish limited liability company because a KGaA was similar to a Swedish LLC. Apparently, the reason why these Swedish subsidiaries were similar was because a KGaA had access to the German *Organschaft*, the German group regime which sought to achieve tax equalization similarly to the Swedish regime at issue. On the other hand, the same court held in *RÅ* 1998 ref 49 that it is not necessary for the foreign parent to have access in its home State to a system for group relief that is similar to the Swedish system in order for the subsidiary to be similar to a domestically-owned company. Therefore, the fact that there was no group relief regime in Cyprus did not preclude the Swedish subsidiary of the Cypriot parent from being ‘similar’ to a domestically-owned company (see K. STÅHL, “The application of the treaty non-discrimination principle in Sweden”, *Intertax* 2000, 199).

[896] U.S. Tax Court 16 January 2001, No. 20381-98, *American Air Liquide and Subsidiaries v Commissioner of Internal Revenue*, 3 *ITLR* 249. The decision was confirmed by the Court of Appeals, No. 01-70627, 29 August 2002, 2002 *WL* 1994118 without, however, substantively addressing the non-discrimination issue.

According to the U.S. rules governing the foreign tax credit, royalties were generally considered to constitute 'passive income'. However, a specific rule applied in the case of controlled foreign corporations (CFC). Under that rule, royalties received or accrued from a CFC in which the taxpayer was a shareholder were treated as 'general limitation income'.

The taxpayer argued that the refusal to characterise the royalties as general limitation income for the purposes of the U.S. foreign tax credit infringed the ownership non-discrimination provision of the French/U.S. treaty. According to the taxpayer, that provision prohibited the royalties in question from being treated less favourably than royalties received by a resident from a CFC.

The Tax Court dismisses that argument. It points out that the taxpayer has received the same treatment as all other similarly situated taxpayers residing in the U.S., that is to say, *"any other domestic corporation receiving royalty income from a non-controlled foreign corporation"*. The fact that the taxpayer's parent company was a French resident played no part in determining the characterisation of the royalty income. As a result, there was no discrimination.

The Tax Court was correct in dismissing the taxpayer's claim, since there is no reason to make the comparison under Art. 24(5) with a resident company having a CFC. Unfortunately, however, the Tax Court considers the appropriate comparison to be with other resident taxpayers receiving royalties from a non-controlled foreign corporation. As will be discussed hereafter, the correct comparison would be with a resident subsidiary which receives royalty income from its resident parent.

II.A. Similarity as a reference to shareholders' residence?

It is not immediately clear what the term 'similar' in Art. 24(5) refers to. A first possibility is that it refers to the residence of the shareholders, that is to say, that a resident company owned by non-resident shareholders is 'similar' to a resident company also owned by non-resident shareholders[897]. Consequently, the comparison would have to be made with other resident companies which are owned or controlled by residents of a third State[898]. That would mean that a company resident in State A and controlled by residents of State B should not be compared to a company resident in State A and controlled by residents of State A, but to a company resident in State A and controlled by residents of State C. If that were the correct interpretation, a beneficial regime which is only available to domestically-owned companies and which excludes all foreign-owned companies would not be prohibitied. Art. 24(5) would only apply if the measure at issue specifically excluded companies owned or controlled by residents of the contracting State in question, while granting the benefit to companies controlled by residents of third States.

A number of treaties expressly provide in that regard whether the comparison should be made with either domestically-owned companies or with companies owned by third-State

[897] For instance, a French company owned by German residents as compared to a French company owned by Italian residents.
[898] That position was taken, for instance, by the U.K. tax authorities until the *Boake Allen* case. See HMRC Double Taxation Relief Manual, para. 1952: *"The proper comparison is not with two companies owned by a United Kingdom resident but with two companies owned by a resident of some other state."* See also J. OLIVER, "Other similar enterprises – NEC Semi Conductors Ltd and others v Inland Revenue Commissioners", *B.T.R.* 2004, 81.

residents[899]. In the absence of such an express provision, there may be some doubt as to the correct comparison, since the Commentary does not address this point directly[900]. However, it seems unlikely that the provision is merely intended to prevent discrimination between different categories of foreign-owned companies since that would significantly reduce its importance. As pointed out above, it could then only be applied where the measure at issue distinguishes between different categories of foreign-owned companies on the basis of their shareholders' residence, which seems improbable. But Art. 24(5) was never intended to have such a narrow scope of application. In the context of the work carried out by Working Party no. 4 (see 1.C), the OEEC Fiscal Committee pointed out that *"it was agreed that the expression 'other similar enterprises established in the territory of that first-mentioned contracting Party' referred to enterprises* ***not under foreign control****"*[901]. This issue was also discussed in the 2007 Discussion Draft on Art. 24, where it is pointed out that: *"the Working Group reached the conclusion that the right comparator for the purposes of paragraph 5 was a domestic enterprise owned by residents but agreed that there was no need to clarify this issue in the Commentary as long as there was no practical reason to do so"*[902].

Consequently, it is clear that Art. 24(5) requires the foreign-controlled company (the subject of comparison) to be compared with domestically-owned companies[903].

II.B. Similarity as a reference to the applicable tax regime?

An alternative interpretation of the term 'similar' is that it refers to criteria used in the domestic law of the contracting State to determine the tax regime applicable to resident companies, apart from the residence of the shareholders. In the first place, it may thus refer to the legal form of the companies concerned. Indeed, for purposes of the taxation of companies, their legal form is often decisive. As a result, it is essential that the foreign-owned company

---

899 A number of treaties concluded by the U.S. specify that the comparison should be made with domestically-owned companies: e.g. Art. 24(3) of the 1970 Belgium / U.S. treaty; Art. 25(3) of the 1971 Norway / U.S. treaty; Art. 21(3) of the 1974 Poland / U.S. treaty. In contrast, a number of treaties concluded by Canada specify that the comparison is to be made with enterprises owned by third-State residents: e.g. Article XXV (5) of the 1980 Canada / U.S. treaty; Article 23(3) of the 1984 Brazil / Canada treaty; Art. 24(4) of the 1999 Algeria / Canada treaty.

900 There is an implicit argument in the Commentary in favour of the comparison with domestically-owned companies. In Comm. OECD on Art. 24, para. 76, it is stated that Art. 24(5) concerns the taxation only of enterprises and not of the persons owning or controlling their capital. Its object therefore is to ensure equal treatment for taxpayers residing in the same State, *"and not to subject foreign capital, in the hands of the partners or shareholders, to identical treatment* ***to that applied to domestic capital****"* (emphasis added). In other words, the provision is not intended to ensure non-discrimination between foreign shareholders and **domestic shareholders**, but between foreign-owned companies and **domestically-owned companies**.

901 FC/M(58)2, 5 (29 March 1958). Similarly, The OECD Report on Thin Capitalisation R(4)-30 points out that Article 24(5) *"aims broadly at preventing 'tax protectionism' - i.e. the deterrence by tax measures of investment* ***from outside the country****"* (emphasis added). This suggests that the provision aims to prohibit differential treatment which is based on a simple distinction between investments by residents and non-residents rather than discrimination against investments by residents of a specific State. See also J. OLIVER, "Other similar enterprises", *B.T.R.* 1989, 142; J. OLIVER, "Differential treatment or discrimination?", *B.T.R.* 1993, 436; R. GOUDSWAARD, "Over gemeenschapsrecht, non-discriminatiebepalingen in belastingverdragen en kapitaalsbelasting", *WFR* 1994/1167, para. 5.1.

902 OECD, "Application and interpretation of Article 24 (non-discrimination). Public discussion draft", 3 May 2007, 27, para. 88. See also S. BRUNS, "Taxation and non-discrimination: clarification and reconsideration by the OECD", *European Taxation* 2008, 488.

903 See also e.g. D. HUGHES, "Non-discrimination: a consideration of Article 24(5) OECD Model Convention", *Bull. IBFD* 1996, 390; J. OLIVER, "Other similar enterprises", *B.T.R.* 1989, 141-146.

and the domestically-owned company are 'similar' as regards their legal form, that is to say, that no distinction as regards taxation is made between them merely on the basis of their legal form. For the purposes of Article 24(5) such a distinction would render them incomparable. Alternatively, where the domestic law governing the taxation of the subject and object of comparison draws a distinction in its tax regime on the basis of the activities carried out by resident companies, then that criterion should also be taken into account in determining whether there is similarity[904].

In other words, the term 'similar' might serve to indicate that contracting States may draw distinctions between resident companies, as long as the distinction is not made on the basis of their being owned or controlled by non-residents. Accordingly, the interpretation of that term depends to a large extent of the legislation of the contracting State in question. If that State taxes all resident companies having the same legal form identically, then similarity is determined by the legal form. If that State uses different criteria, such as the type of activities carried out, then those criteria determine similarity.

A comparable position is taken by the U.S. in a number of Technical Explanations accompanying their tax treaties, where it is stated that Article 24(5) *"does not prohibit differing treatment of entities that are in differing circumstances. Rather, a protected enterprise is only required to be treated in the same manner as other enterprises that,* ***from the point of view of the application of the tax law****, are in substantially similar circumstances both in law and in fact"* (emphasis added)[905]. The wording used in that statement is remarkably similar to the OECD Commentary on Art. 24(1), which provides that *"the expression 'in the same circumstances' refers to taxpayers […] placed, from the point of view of the application of the ordinary taxation laws and regulations, in substantially similar circumstances both in law and in fact"*[906].

However, Article 24(5) does not include a reference to "the same circumstances", so it is questionable whether that interpretation – and particularly the reference to "substantially similar circumstances in fact" – can be applied here.

The Technical Explanation to a number of other U.S. treaties address this issue further and point out that measures do not fall foul of Art. 24(5) if a distinction is made on the basis of whether the parent company is liable to corporate tax. Under that interpretation, national legislation would not constitute discrimination contrary to the ownership provision if a tax benefit is denied not only to to domestic companies with a foreign parent (which is by definition not subject to U.S. corporate tax) but also to domestic companies with a domestic tax-exempt parent[907]. The argument is that the distinction is then not made on the ba sis of the residence of the domestic company's owners, but on the basis of their being subject to corporate tax.

[904] See the reference made earlier to the treaties containing an express requirement that the object of comparison is carrying out the same activities. See also K. VOGEL, *o.c.*, 1332.
[905] E.g. Technical Explanation to the 2006 Belgium/U.S. treaty, p. 93; Technical Explanation to the 1998 Latvia/U.S. Treaty, p. 82). The language of that clarification seems to stem from I.R.S. Notice 87-66, 1987-2 *C.B.* 376.
[906] Comm. OECD on Article 24, para. 7.
[907] E.g. Technical Explanation to the 1975 Israel/U.S. treaty, p. 52; Technical Explanation to the 1996 Thailand/U.S. treaty, p. 77; Technical Explanation to the 1997 Ireland/U.S. treaty, p. 87.

Under that argument, a foreign parent company is considered to be similar to a domestic tax-exempt company, which it clearly is not[908]. Additionally, being subject to corporate tax is a direct consequence of the foreign parent's non-residence, which means that it should be left out of the comparability-analysis: as mentioned before, elements that are inextricably linked with the comparative attribute should be left out of the analysis[909].

Reference should also be made to a related issue addressed in the 2007 Discussion Draft. In the context of the tax treatment of groups of companies, the Discussion Draft points out that, unlike Art. 24(1), Art. 24(5) does not explicitly require that the enterprises must be in the same circumstances. It is then noted, however, that "*the term 'similar enterprises' might imply that they should be comparable and that this is not always the case. The term 'similar enterprises' might suggest that paragraph 5 is dealing with companies as separate entities only and that as far as transactions between the subsidiary and the parent are concerned, the subsidiary of a domestic parent might not be a similar enterprise. Also, the question has been raised whether or not an enterprise is 'similar' if the foreign parent company is not necessarily subject to national taxes on a worldwide basis*"[910].

This odd statement, which is not included in the 2008 update, is not very convincing. Indeed, there is nothing to suggest that 'similar' refers to a 'separate entity' approach. Moreover, it is doubtful whether that argument can support the conclusion that, in the context of group transactions, the subject of comparison is not 'similar' (or comparable) to a resident subsidiary of a resident parent. It is true that Art. 24(5) does not cover rules that concern the combined tax treatment of the subsidiary and its parent company (see supra), but that has little to do with comparability. The reason why such rules go beyond the scope of Art. 24(5) is that that provision only concerns the taxation of the subsidiary, not that of the group as a whole. Finally, if one accepts that the provision concerns the taxation of the subsidiary as a 'separate entity', as the Discussion Draft does, then the fact that the foreign parent is not subject to tax on a worldwide basis is irrelevant for the comparison[911].

II.C. Similarity as a reference to all relevant circumstances other than foreign ownership

Given the strict scope of application of Art. 24(5), described above, it seems that similar does not add anything substantial to the interpretation of the prevision. As discussed above, Art. 24(5) is only concerned with discrimination solely on the basis of foreign ownership. As a result, all other elements – that is to say, all relevant elements apart from foreign ownership – must be identical among subject and object of comparison. The term 'similar' does not add anything to that requirement[912]. Instead, it could be seen as merely stressing the importance of this aspect of the comparability-analysis.

---

[908] J. AVERY JONES, "The non-discrimination article in tax treaties: Part 2", *B.T.R.* 1991, 440.

[909] See supra, 2.B.V, where this issue was addressed in relation to the nationality non-discrimination provision.

[910] OECD, "Application and interpretation of Article 24 (non-discrimination). Public discussion draft", 3 May 2007, 7, para. 11.

[911] See also J. AVERY JONES, "Understanding the OECD Model Tax Convention: the lesson of history", *Florida Tax Review* 2009, 47-48.

[912] See also K. VAN RAAD, , *Nondiscrimination in international tax law*, 1986, Kluwer, Deventer, 89 and 189, who argues that similarity between subject and object of comparison is inherent in the concept of non-discrimination. As a result, the expression 'similar' does not add anything to the meaning of Art. 24(5). He made a similar point with respect to the expression 'in the same circumstances' in Art. 24(1). On that issue, see 2.B.V.A.

Thus, the decisive question in constructing the object of comparison is which elements are relevant in the context of the domestic rule at issue. As illustrated by the *Boake Allen* case, which will be discussed in 2.F.II.D.d, it cannot be excluded *a priori* that elements relating to the tax position of the non-resident parent may be 'relevant' as well. It is necessary in each case to determine which elements are relevant for the domestic rule at issue. Obviously, that assessment will not always be entirely straightforward.

II.D. Case law

a. Swedish Supreme Administrative Court 19 November 1987[913]

A company resident in the Netherlands was the sole shareholder of two Swedish companies. One of the Swedish subsidiaries held shares in a third Swedish company, which it wished to transfer to the other subsidiary. Swedish tax law provided that where a shareholding was transferred to a Swedish company within the same group, no tax was levied on the gains realised. Instead, the transferee was regarded as having acquired the shareholding on the date of the transferor's acquisition and for the transferor's acquisition cost. However, in order for that deferral regime to apply, the parent company of the group had to be a Swedish company. If the parent was a foreign company, as it was in the present case, the gains were taxed.

The taxpayer argued that this distinction infringed the ownership non-discrimination provision of the Dutch/Swedish tax treaty[914].

The Judicial Commission of the National Tax Board held in favour of the taxpayer. The Commission first refers to Comm. OECD on Art. 24, para. 76, where it is stated that the object of Art. 24(5) is to ensure equal treatment for taxpayers residing in the same State (see supra). The Commission holds that, in view of the object of the non-discrimination provision as expressed in the Commentary, the requirement that the parent company must be Swedish in order to qualify for the deferral constitutes discrimination. Therefore, the Commission decides that the taxpayer should be able to enjoy the deferral regime in the case at hand.

The tax authorities objected against that decision to the Supreme Administrative Court, which confirmed the Commission's decision both in regard to its holding and its reasoning. Consequently, both the Commission and the Supreme Administrative Court consider that the correct comparison under Art. 24(5) is with domestically-owned companies, not with companies owned by third-State residents.

b. Dutch Supreme Court 23 December 1992[915]

A U.S. resident company (the parent) had a German subsidiary, which had a PE in the Netherlands. Additionally, the U.S. company held all the shares in a company established in the Netherlands (the Dutch subsidiary) through the intermediary of a Dutch holding company. As part of a corporate reorganization, the PE was transferred to the Dutch subsidiary. The assets of the PE included immovable property situated in the Netherlands.

---

913 Regeringsrätten No. 2225-1987, 19 November 1987, discussed in J. KESTI, "Foreign parent did not preclude favourable treatment of stock transfer within a concern", *E.T.* 1988, 401-404 and R. PAPOTTI, "Treaty non-discrimination clauses in group consolidation situations", *Intertax* 2003, 323.
914 Art. 27(4) of the 1968 Dutch/Swedish treaty, which is identical to Art. 24(5) OECD MC.
915 Hoge Raad 23 December 1992, No. 27.843, *BNB* 1993/71.

In the Netherlands, the transfer of immovable property generally gave rise to transfer tax liability for the transferee, but an exception was provided for if the transaction was carried out as part of an internal reorganization of companies established in the Netherlands. Since the transfer in the present case was made between a German company and a Dutch company, the Dutch tax authorities refused the exemption from transfer tax. Moreover, the exemption could only be applied if the transferor and the transferee belonged to a group in which the parent company was also a Dutch company. In the present case, that condition was not met since the parent company was established in the U.S.

Consequently, two questions of discrimination arose. First, whether it constituted discrimination to restrict the exemption to transactions made between Dutch companies and, secondly, whether it constituted discrimination to restrict the exemption to transactions made within a group in which the parent company is also a Dutch company.

The Supreme Court addressed the first question from the perspective of EU tax law[916] and therefore asked the ECJ whether the distinction made by the legislation at issue fell foul of the freedom of establishment[917].

The Supreme Court then addressed the second question on the assumption that the ECJ would consider the first issue to give rise to an infringement of the freedom of establishment. For that reason, the Supreme Court equates the German subsidiary to a Dutch subsidiary. In other words, the Supreme Court answers the second question as if the German subsidiary was a Dutch subsidiary, i.e. as if the case involved a U.S. parent with two Dutch subsidiaries. The Supreme Court thus verifies whether the second issue implies an infringement of the ownership non-discrimination provision of the Dutch/U.S. treaty[918].

In that respect, the Court held that the restriction of the exemption to groups in which the parent company was established in the Netherlands fell foul of that provision because it resulted in less favourable taxation of the subsidiary than if the parent had been established in the Netherlands.

c. Dutch Supreme Court 27 April 1994

1. Three similar cases

The Dutch Supreme Court rendered three decisions on the same day concerning the Dutch legislation on capital tax. Under that legislation, any contribution in cash or in kind to the risk-bearing capital of a company resident in the Netherlands was, in principle, subject to

[916] The issue was also briefly addressed from the perspective of the nationality non-discrimination provision of the Dutch/German tax treaty, but the Supreme Court correctly held on that point that there was no discrimination because the refusal of exemption (and, hence, the discrimination) concerned the transferee, a Dutch company. Since only the transferee was liable to the transfer tax, there was no ‘less favourable taxation’ of a national of the other contracting State. As will be pointed out in Part III, 2.E.II.C.c, the ECJ nevertheless held such ‘derivative’ discrimination to fall foul of the freedom of establishment.

[917] The ECJ answered that question in the positive, see C-1/93, *Halliburton*, 12 April 1994.

[918] Art. XXV(4), which is identical to Art. 24(5) OECD MC, apart from two deviations. First, Art. XXV(4) expressly provides that the comparison should be made with a domestically-owned company (see supra). Secondly, that provision did not refer to capital which is owned or controlled “directly or indirectly” by a resident of the other contracting State. In the present case, the parent held the shares in the transferor indirectly (i.e. through the intermediary of the holding company) but the Supreme Court nevertheless applied Art. XXV(4). According to the Court, the purpose of that provision implied that indirect ownership should be covered as well.

capital duty. The capital duty was levied from the company in which the capital was contributed.

An exemption from capital duty applied on the condition that the company contributing the capital was a resident of an Member State. Accordingly, the domestic law at issue did not distinguish on the basis of residence in the Netherlands, but on the basis of residence in a Member State. This was due to the fact that the domestic legislation in question was the implementation of a European Directive, namely Directive 69/335/EEC concerning indirect taxes on the raising of capital[919]. The Supreme Court was asked whether the ownership non-discrimination clause requires tax benefits granted pursuant to the implementation of a European Directive to be extended to resident companies owned by parent companies established in a third country, even though the Directive in question only concerns transactions between companies established in Member States.

a. The treaty with Sweden

The first case concerns a Swedish parent company with a subsidiary in the Netherlands[920]. In 1989, the Dutch subsidiary issued new shares to its Swedish parent company. In return, the parent transferred part of its business to the Dutch subsidiary.

Pursuant to Art. 7 of Directive 69/335/EEC, the transfer of the part of a company's business to another company was exempt from capital tax if the companies taking part in the transaction were established in a Member State[921]. That provision was implemented in Dutch tax law[922]. Since the transferor in the present case was established in Sweden, the Dutch tax authorities assessed the Dutch subsidiary to capital tax. The Dutch subsidiary argued that that assessment was contrary to the ownership non-discrimination clause in the Dutch/Swedish tax treaty[923].

The Amsterdam Court of Appeal dismissed the taxpayer's argument and held that the term 'similar' meant that the comparison should be made with a resident company to which assets are transferred by another company that is not established in a Member State. Since resident companies were never entitled to the exemption if the transferor was established in a third country, there was no discrimination contrary to the tax treaty. This approach to similarity is the narrow interpretation, discussed above, under which similarity refers to the residence of the shareholders.

The Supreme Court dismissed that approach, pointing out that the transfer would have been exempt if the parent company had been established in the Netherlands. The Supreme Court held that the purpose of the ownership non-discrimination clause was to prevent less favourable treatment of companies established in one of the contracting States depending on whether their capital is held by residents of either that contracting State or the other

[919] Council Directive 69/335/EEC of 17 July 1969 concerning indirect taxes on the raising of capital, *O.J.* L 249 , 3 October 1969, 25-29, as amended by Council Directive 85/303/EEC of 10 June 1985, *O.J.* L 156, 15 June 1985, 23-24.
[920] Hoge Raad 27 April 1994, No. 28.239, *BNB* 1994/207.
[921] See Art. 7(b) of the Directive.
[922] There were a number of additional issues concerning the interpretation of the Directive, but since those issues did not affect the Supreme Court's analysis of the discrimination argument, they will not be addressed here. However, as will be pointed out below, the Directive was not implemented correctly in the Netherlands, with the result that the Supreme Court gave direct effect to the provisions of the Directive.
[923] Art. 27(4) of the 1968 treaty, which is identical to Art. 24(5) OECD MC.

contracting State. As a result, the expression 'other similar companies" did not refer to Dutch companies the capital of which is held by a company established in a State **other than the Netherlands and Sweden**, but to 'similar' Dutch companies the capital of which is held by a company established **in the Netherlands**[924]. As a result, denying the exemption on the basis that the transferor was not established in an Member State but in Sweden constituted an infringement of the ownership non-discrimination clause.

Finally, the Supreme Court held that the fact that the distinction was not made on the basis of the parent company's residence, but on the basis of the residence of the transferor did not affect this conclusion. The Court pointed out that, in the case of a capital contribution in a company, shareholder status and contributor status are so closely interwoven that discrimination on the basis of the contributor's status should also be considered as discrimination on the basis of the shareholder's status[925].

b. The treaty with Japan

The Supreme Court took the exact same approach in the second case, which concerned a Dutch company with a Japanese parent company[926]. Additionally, the Court also addressed the argument, brought forward by the Dutch tax authorities, that applying the exemption in the present case would mean that an overly broad application would be given to a tax benefit that is only meant for companies established in an Member State.

The Supreme Court dismisses that argument, noting that it is based on the incorrect assumption that the non-discrimination clause of the tax treaty is incompatible with the Directive, in which case the Directive should be given priority. While it is true that the scope application of the Directive is restricted to transactions between companies established in a Member State, the Court points out that that does not mean that the Directive precludes the extension of the exemption to other situations. The Directive only provides that Member States are required to grant the exemption for transactions between companies established in Member States. Apart from that obligation, Member States are free to apply the exemption in other cases as well. In doing so, the Member States are in no way failing to meet their obligations under the Directive. Since European law does not prohibit the extension of the benefit to companies owned by third-State residents, there is no incompatibility between the non-discrimination clause in the tax treaty and European law.

---

[924] See para. 3.6 of the decision: *"De strekking van artikel 27, lid 4, van het Verdrag, het tegengaan van een verschil in behandeling van een in één van de staten gevestigde onderneming naar gelang het kapitaal in handen is van inwoners van de ene dan wel van de andere staat, brengt mede dat met 'andere soortgelijke ondernemingen van Nederland' niet wordt gedoeld op ondernemingen gedreven door in Nederland gevestigde vennootschappen waarvan het kapitaal in het bezit is van lichamen die zijn gevestigd in een andere staat buiten Nederland dan Zweden, maar op - soortgelijke - ondernemingen gedreven door in Nederland gevestigde vennootschappen waarvan het kapitaal in het bezit is van niet in Zweden maar in Nederland gevestigde vennootschappen."*

[925] See para. 3.7 of the decision: *"De […] vestigingseis bewerkte formeel niet een verschil in behandeling op grond van de vestigingsplaats van de moedermaatschappij maar een verschil in behandeling op grond van de vestigingsplaats van het inbrengende lichaam. Echter, bij inbreng zijn het aandeelhouderschap en de hoedanigheid van inbrenger zozeer met elkaar verweven dat een discriminerende behandeling op grond van een hoedanigheid van de inbrenger tevens moet worden beschouwd als discriminatie op grond van een hoedanigheid van de aandeelhouder."*

[926] Hoge Raad 27 April 1994, No. 28.603, *BNB* 1994/209.

c. The treaty with the U.S.

The third case concerns a Dutch company that was established by a U.S. company[927]. In return for the shares issued by the newly established company, the U.S. parent transferred part of its business to the Dutch subsidiary. As in the previous cases, the question arose whether that transfer could benefit from the exemption from capital tax. Once again, the Supreme Court took the same approach as in the other two cases and granted the exemption on the basis of the ownership non-discrimination clause.

In this case, the Court was a bit more elaborate on the issue that the distinction was not made on the basis of the parent company's residence, but on the basis of the residence of the transferor. The Court pointed out that the U.S. company had obtained shareholder status as a result of its contribution, i.e. as a result of the transfer. For that reason, shareholder status and contributor status are so closely interwoven that discrimination on the basis of the contributor's status should also be considered as discrimination on the basis of the shareholder's status.

2. Analysis

a. 'Other similar enterprises'

The first interesting aspect of these cases is the interpretation given to the expression 'other similar enterprises'. As discussed earlier, that expression should not be interpreted as referring to the residence of the shareholders of the object of comparison. If that were the case, the subject of comparison can only be compared with a resident company the capital of which is held by residents of a third State (i.e. residents of neither of the contracting States).

In the three cases discussed here, the Supreme Court takes the same approach and correctly decides that the comparison should be made with a resident company the capital of which is held by residents of that same State. Apart from that, however, the Court does not address what is precisely meant by 'similar'.

b. Discrimination on the basis of the contributor's residence

Another interesting issue is the fact that the domestic legislation at issue does not distinguish on the basis of the shareholder's residence, but on the basis of the contributor's residence. In

[927] Hoge Raad 27 April 1994, No. 28.674, *BNB* 1994/210. In this case, the question did not arise whether 'similar' referred to the residence of the shareholders, since the applicable Dutch/U.S. treaty expressly provided that the comparison had to be made with a domestically-owned company. See Art. XXV(4) of the treaty: *"A corporation of one of the Contracting States, the capital of which is wholly or partly owned by one or more citizens or corporations of the other Contracting State, shall not be subjected in the former Contracting State to more burdensome taxes than is a corporation of the former Contracting State,* ***the capital of which is wholly owned by one or more citizens or corporations of that former Contracting State****"* (emphasis added). Additionally, the treaty with the U.S. did not refer to discrimination on the basis of the shareholders' residence, but on the basis of their nationality (unlike the treaties with Japan and Sweden, which follow the OECD MC). The Supreme Court nevertheless considers that the domestic measure infringes that provision because a company incorporated under the law of the U.S. is not likely to be a resident of an EU Member State, while a company incorporated under the law of the Netherlands is deemed to be a resident of the Netherlands for the purposes of the capital tax (and, therefore, entitled to the exemption) even if its place of effective management is elsewhere. As a result, a company incorporated in the Netherlands is always entitled to the exemption, while a company incorporated in the U.S. generally is not (see para. 4.6 of the decision). That approach is questionable because Art. 24 does not cover indirect discrimination (see supra).

that respect, the Supreme Court repeatedly holds that, in the context of a contribution in a company, those two elements are so interwoven that they amount to the same thing.

That is a remarkable approach. It is quite possible that, at the moment of the contribution, the contributor is not a shareholder of the resident company. In such a case, it is questionable whether there is discrimination on the basis of the shareholder's residence. In the third case, the Supreme Court seems to clarify its approach by pointing out that the contributor **obtains** shareholder status **as a result** of the contribution, which explains why being a contributor and being a shareholder is interwoven to such a degree. However, that argument is not immediately clear. It is true that the contribution results in the contributor obtaining shareholder status, but **at the moment of the taxable event** (i.e. the contribution), he is not yet a shareholder. And the (less favourable) taxation takes place at that moment. For that reason, it could be difficult to understand that there is discrimination on the basis of the shareholder's residence. Indeed, Art. 24(5) prohibits discrimination of companies the capital of which is owned by residents of the other contracting State, which implies that the capital **is already** owned by such residents at the moment of the discrimination.

However, it is important to distinguish two issues in this respect. The first issue, which is described in the preceding paragraph, is that a cause necessarily precedes its effect (propter hoc, ergo post hoc)[928]. In other words, since the shareholder status is caused by the contribution, the contribution necessarily precedes the shareholder status. For that reason, it could be argued that there is no discrimination on the basis of shareholder status since, when the discrimination occurred, the contributor was not yet a shareholder.

But there is also a second issue, entirely separate from the temporal nature between cause and effect. Assuming that making a contribution in a company **necessarily** results in shareholder status, it could be argued that contributor status and shareholder status are inseparable[929]. Even though the contributor is not yet a shareholder at the moment of the contribution, it is clear that his contribution will make him a shareholder. For that reason, it could be argued that discrimination on the basis of contributor status is the same as discrimination on the basis of shareholder status, regardless of the temporal asymmetry between those capacities. If the chronological split is disregarded, it is clear that both capacities are inextricably linked. Arguably, that is what the Dutch Supreme Court referred to when it held that contributor status and shareholder status are so closely interwoven that discrimination on the basis of the contributor's status should also be considered as discrimination on the basis of the shareholder's status.

[928] D. HUME, *A Treatise of Human Nature*, 2007, Oxford University Press, 54: *"The second relation I shall observe as essential to causes and effects, is not so universally acknowledged, but is liable to some controversy. It is that of PRIORITY of time in the cause before the effect."*

[929] The present discussion is limited to the situation where making a contribution results in shareholder status, i.e. contributions in exchange for shares. Strictly speaking, the term 'contribution' as it was used under the legislation at issue does not only refer to contributions in exchange for shares, but also to contributions of capital – in cash or in kind – made by a shareholder in his capacity as such, but which do not relate to an issue of shares (so-called 'informal capital contributions'). In the latter situation, the contribution does not result in the contributor obtaining shareholder status. Indeed, the contributor already necessarily has shareholder status at the moment of the contribution (since it concerns contributions in capital made by a shareholder in his capacity as such). Worded differently: in that situation, it is clear that being a contributor is inextricably linked with being a shareholder. Therefore, a distinction between resident and non-resident contributors necessarily amounts to a distinction between resident and non-resident shareholders.

However, neither the text of the OECD MC, nor the Commentary clarify whether the non-discrimination provision should also apply to such situations[930]. For that reason, it is necessary to consider the object and purpose of Art. 24(5)[931]. The Commentary is quite concise on this issue, and only points out that the provision is intended to protect the enterprise from discrimination, rather than the persons owning or controlling its capital. Consequently, the object of Art. 24(5) is **not** to ensure equal treatment of foreign capital and domestic capital[932]. A first possible approach could be to infer from that basic purpose that Art. 24(5) does not seek to prohibit discrimination in the context of the initial investment decision. The provision is not concerned with the tax treatment of foreign capital as such, nor therefore with the tax treatment of capital contributions. Under that interpretation, Art. 24(5) is only relevant after the initial investment, when the resident company is owned or controlled by non-residents. Accordingly, Art. 24(5) should not be applied when the discrimination is on the basis of the contributor's residence rather than on the basis of the shareholder's residence.

In my opinion, however, that interpretation is too restrictive and it would create an artificial distinction in the scope of application of Art. 24(5). As noted above, the purpose of Art. 24(5) is to protect foreign-owned enterprises from discrimination as compared to domestically-owned enterprises. Underlying that purpose is the idea that such non-discriminatory treatment stimulates reciprocal trade by ensuring a competitive market in the host State, free from discriminatory tax obstacles. From that perspective, it is clear that the initial investment decision should be protected as well[933]. If the purpose of the provision is to ensure free competition between investors resident in both contracting States, it is essential that non-resident investors are free to enter the market to begin with, i.e. that the host State should not fence off its market by imposing discriminatory access measures. Free competition implies not only that market participants are treated in a non-discriminatory manner, but also that the initial access to the market is not hindered by discriminatory obstacles. As a result, if the contribution is necessarily linked with shareholder status, it should also be covered by Art. 24(5).

> It has been argued that the situation is more clear-cut if the measure at issue applies to contributions made upon the establishment of a company. In such a case, the person incorporating the company is the sole shareholder at the moment the contribution is made, and for that reason, the 'interwovenness' of the shareholder status and the contributor status is even clearer because there are no other shareholders apart from the contributor[934]. I do not

---

930 It could be suggested that there is a textual argument in the provision itself, since it applies to companies, *"the capital of which* ***is*** *[…] owned or controlled"* by residents of the other contracting State. The use of the present 'is' implies that the resident of the contracting State must be a shareholder at the moment of the discrimination (see supra). However, the point made by the Supreme Court is exactly that contributing capital is equivalent to **being** a shareholder, meaning that it should be treated identically. So under that argument the contributor should already be treated as a shareholder at the moment of the contribution.

931 Art. 31(1) Vienna Convention.

932 Comm. OECD on Art. 24, para. 76. A similar position was taken by Working Party no. 4 of the OEEC Fiscal Committee: *"paragraph (5) and the discrimination to which it puts and end relate to the taxation only of enterprises and not of the persons owning or controlling their capital. […] There is no question, therefore, of this provision ensuring the same treatment for foreign capital as for domestic capital, but rather of ensuring equal treatment for taxpayers domiciled in the same State. The provision in question has no connection with nationality and, in particular, it does not introduce a new concept of 'nationality of capital'"* (FC/WP4(57)3, 13 September 1957, 13).

933 See also the OECD Thin Cap Report, § 66b, where it is stated that Art. 24(5) *"aims broadly at preventing 'tax protectionism' - i.e. the deterrence by tax measures of investment from outside the country."*

934 J. ZWEMMER, note under Hoge Raad 27 April 1994, No. 28.674, *BNB* 1994/210, para. 4. Similarly, C. PETERS, "The Netherlands", in IFA, *Cahiers de droit fiscal international. Non-discrimination at the crossroads of international taxation*, Vol. 93a, Amersfoort, Sdu Fiscale & Financiële Uitgevers, 2008, 418 (*"In all of these*

> support that view. There is no reason to take a different approach in such a case, merely because there are no other shareholders. Indeed, the position of the contributor is not altered by the fact that there are no other shareholders present at the moment the contribution is made. Both situations should be covered by Art. 24(5).

c. Extension of the benefits of a Directive to situation involving third State

A final interesting aspect is that the Supreme Court extends benefits granted pursuant to a European Directive to transactions involving parties established in third States. That is quite remarkable, especially in the cases involving Sweden and the U.S. In the case concerning the Japanese parent company, the Directive was correctly implemented in the Netherlands. As a result, had the contributor been established in the Netherlands (or another Member State), the exemption would have been granted on the basis of domestic law. In this context, the Dutch tax authorities argued that applying the exemption in the case at hand would mean that an overly broad application would be given to a tax benefit that was specifically granted in the context of the EU and was therefore only meant for companies established in a Member State. The Supreme Court dismissed that argument on the basis that the Directive did not preclude the Netherlands from extending the benefit to transactions involving other companies. As a result, there was no incompatibility between the non-discrimination provision of the tax treaty and the Directive.

In the cases involving Sweden and the U.S., the Court's position is even more striking. In those cases, the relevant provisions of the Directive had not been implemented correctly in the Netherlands at the time of the transaction. Consequently, had the contributor been a resident of the Netherlands (or another Member State), it would have been impossible to rely on domestic law. Instead, the contributor would have to rely on the direct effect of the Directive in order to claim the exemption. Nevertheless, the Supreme Court held that the ownership non-discrimination provision required the exemption to be extended to the contributions made by the Swedish and U.S. parent company.

In other words, the Supreme Court extends the benefits of a European Directive to transactions involving a third State resident. That is not an actual MFN-interpretation of the non-discrimination provision, since the favourable treatment (i.e. the exemption) is not granted to a resident of a third State, but to a resident of a Member State who carries out a transaction with a resident of a third State. Nevertheless, it is questionable whether Art. 24 OECD MC can be interpreted so broadly. As pointed out earlier, the 2008 Update to the OECD MC has clarified that Article 24 cannot be interpreted as to require most-favoured-nation treatment. The Commentary now points out that, *"where a State has concluded a bilateral or multilateral agreement which affords tax benefits to nationals or residents of the other Contracting State(s) party to that agreement, nationals or residents of a third State that is not a Contracting State of the treaty may not claim these benefits by reason of a similar non-discrimination provision in the double taxation convention between the third State and the first-mentioned State"*[935].

---

cases this observation was correct because of the fact that the contributing companies were the sole shareholders of the Dutch companies involved") and K. VALKENBURG, "Holding structures and exemptions from capital duty. An overview of recent developments concerning non-discrimination provisions in tax treaties", *European Taxation* 1995, 175.

[935] Comm. OECD on Art. 24, para. 2.

The benefits granted pursuant to a European Directive are inspired by the specific objective of establishing an internal market. That objective explains why the benefits granted under a Directive, or under a similar instrument of European integration, cannot be extended to third State-residents under the provisions of a tax treaty between that third State and a Member State. The same is true where the benefits are claimed not by a third State-resident, but by a resident of a Member State who carries out a transaction with a third State-resident, while the benefits are intended to remain confined to transactions between residents of Member States.

This issue is similar to the actual MFN-issue, i.e. the situation where a taxpayer invokes the non-discrimination provision of the treaty between his State of residence and another State in order to enjoy benefits granted in a tax treaty between that other State and a third State. In such a situation, the principle of reciprocity, which is inherent in a tax treaty, explains why the benefits of the latter treaty should remain confined to the residents of both contracting States[936]. Here, the obstacle to extending the benefits to situations involving third States is not merely the absence of reciprocity, but the fact that 'European legislation' creates a specific legal order, which is characterised by a common pursuit of market integration. For that reason, the benefits granted under such European legislation do not form part of the national treatment to which a third State-resident is entitled pursuant to the non-discrimination provisions of the tax treaty between his State of residence and a Member State.

d. Boake Allen[937]

1. The decision of the House of Lords

The *Boake Allen* case (which is sometimes referred to as *NEC Semi-Conductors*) was touched upon earlier, in 2.B.VII.C. As pointed out there, the case concerns the U.K. regime of advance corporation tax (ACT). Under that regime, a company resident in the U.K. which paid a dividend was liable to pay ACT, calculated as a percentage of the amount of the dividend. The ACT had two functions. First, it was a prepayment of the distributing company's corporation tax liability and could thus be set off against its liability for corporation tax on its profits ('mainstream corporation tax' or MCT). If the distributing company had no taxable profits for that period but nevertheless paid a dividend, the ACT was an actual cost. Secondly, the recipient of the dividend was entitled to a tax credit for the ACT. If the recipient was a company, the income received (i.e. the dividend and the tax credit) was exempt and could be distributed to the recipient's own shareholders without further payment of ACT. Accordingly, if distributed profits passed through a chain of several companies, only the first to pay a dividend paid ACT.

Furthermore, it was possible under that regime for a parent and subsidiary, both resident in the U.K., to jointly elect that the subsidiary would pay dividends free of ACT and that the parent would receive them without the benefit of a tax credit ('group election regime'). The dividends would not be exempt in the hands of the parent and the parent would be liable for ACT when it passed them on as dividends to its own shareholders. The group election regime thus gave related resident companies the opportunity to decide between themselves who should pay ACT and when it should be paid. The advantage to the group was that money could be moved from subsidiary to parent without attracting an immediate liability to ACT.

The *Boake Allen* case concerned a U.K. resident subsidiary of a U.S. resident parent company and a U.K. resident subsidiary of a Japanese resident parent company. Since the parent

[936] See supra, 2.B.VI.D.b (on the decision of the Dutch Supreme Court of 14 June 1972).
[937] House of Lords 23 May 2007, 9 ITLR 995.

company in both cases was a non-resident, it was impossible to elect that the dividends would be paid without attracting ACT liability. The question arose whether the denial of such a right of election if the parent was not a U.K. resident violated the ownership non-discrimination provision. Both the U.K./U.S. treaty and the Japanese/U.K. treaty contained an ownership non-discrimination clause identical to Art. 24(5) OECD MC.

Both the first instance court and the court of appeal decided in favour of the taxpayer and held that there was discrimination because a resident company which was the subsidiary of a U.S. or Japanese parent was subjected to taxation (i.e. payment of ACT) which a similar enterprise, namely a resident subsidiary of a U.K. parent, would not have to pay if they had made an election[938]. Accordingly, both courts considered it irrelevant that an election would transfer liability for ACT to the U.K. parent but not the U.S. or Japanese parent (since a non-resident is not liable to ACT). The courts argued in this respect that the ownership non-discrimination provision is only concerned with the taxation of resident companies and not with the tax position of their non-resident shareholders. Support for this interpretation was found in the Commentary, where it is stated that the purpose of that provision is to ensure equal treatment for taxpayers residing in the same State, and not to subject foreign capital in the hands of the shareholders to identical treatment to that applied to domestic capital.

The House of Lords took a different position[939]. It first held that the observation in the Commentary, concerning the purpose of Art. 24(5), was irrelevant in the present discussion since that observation was directed to a different point: it drew attention to the limited application of the ownership non-discrimination provision, which provides only for treatment of resident taxpayers and does not prevent a State from discriminating as regards the income of foreign shareholders, for instance by imposing a withholding tax. The House of Lords therefore pointed out that that observation in the Commentary *"does not say that parentage cannot be a relevant characteristic of a resident taxpayer."*

According to the House of Lords, the decisive question is whether the U.K. rule at issue discriminates against a U.K. company on the ground that its capital is owned or controlled by non-residents. In the context of Art. 24(1), the Commentary points out that the underlying question is whether two persons who are residents of the same State *"are being treated differently solely by reason of having a different nationality"*[940]. That observation is not repeated in relation to Art. 24(5) but the House of Lords holds that the principle must be the same.

Applied to the present case, the House of Lords decides that the U.K. measure at issue does not discriminate on the basis of foreign ownership. For example, if a U.S. parent were to interpose a U.K. resident holding company between itself and its U.K. resident subsidiary, the control would remain in the U.S. but there would be no objection to an election by the U.K. subsidiary and its immediate U.K. resident parent.

On the other hand, an individual U.S. shareholder and a company he controls in the U.K. cannot elect but the reason is **not** because the company is controlled by a U.S. resident. Indeed, an individual U.K. resident shareholder and his resident company would not be able

[938] Court of Appeal 31 January 2006, 8 *ITLR* 819, paras. 34-44; High Court, Chancery Division 24 November 2003, 6 *ITLR* 416, paras. 26-33.
[939] House of Lords 23 May 2007, 9 ITLR 995, paras. 15-23. Since the decision was unanimous on this point, I will not refer to the positions taken by the different Lords individually.
[940] Comm. OECD on Art. 24, para. 8.

to elect either. The reason is that an individual (resident or not) is not liable to corporation tax. The same is true for a non-resident company: the reason why the election is not possible is that a non-resident company is not liable to corporation tax in the U.K. An election is a joint decision by two entities paying and receiving dividends that one rather than the other will be liable for ACT. According to the House of Lords, that concept cannot be meaningfully applied when one of the entities is not liable to ACT at all[941].

The House of Lords therefore holds that it is not possible to decouple the positions of parent and subsidiary as the first instance court and the court of appeal did. To allow an election by a group with a U.S. resident parent would not be to give a relief available to a group with a U.K. resident parent. It would not be an election as to who would be liable for ACT but as to whether the group should pay it at all.

In fact, that argument was also put forward by the U.K. government in the ECJ's decision in *Metallgesellschaft* but it was rejected there[942]. According to the House of Lords, that was because the freedom of establishment has a different purpose from the prohibition of discrimination in a tax treaty. The freedom of establishment is the freedom of a resident of a Member State to establish itself in another Member State, for instance by establishing a subsidiary. A resident's freedom of establishment is thus infringed when the host State imposes restrictions on such a subsidiary. Accordingly, discrimination against the group as a whole infringes the parent company's freedom of establishment. If a group with a U.K. parent company has a cashflow advantage which a group with a parent company in another Member State does not enjoy, the latter parent's freedom of establishment has been restricted. In the present case, there is a restriction in the host State (the U.K.) since that State allows resident subsidiaries of resident parent companies to make the election, while resident subsidiaries of non-resident parent companies are unable to do so. The House of Lords points out that, in order to remedy that restriction, it would not have been possible simply to give a group with a parent company in another Member State the right to elect. That would enable the group not to pay ACT and put it in a better position than a group with a U.K. parent. It would therefore have been necessary to either repeal the election regime or to abolish ACT altogether[943].

In contrast, a tax treaty does not give residents of a contracting States a right of establishment in the other contracting State. As pointed out in the Commentary, the equality it ensures is only that a company owned by a resident of a contracting State in the other contracting State will not be subject to taxation which discriminates on the ground of its foreign control. According to the House of Lords, the denial of the right of election was not on the ground of the company's foreign control but on the ground that it could not be applied to a case where the parent company is not liable to ACT.

---

[941] See also House of Lords 8 February 2006, Pirelli Cable Holding NV v Inland Revenue Commissioners, 8 *ITLR* 872, para. 19: *"A group income election is a* ***group*** *election. A group income election cannot be made by a subsidiary alone. It is an election made jointly by the subsidiary paying the dividend and the parent receiving the dividend. By making such an election both companies seek the fiscal consequences of making the election. One consequence is that by making the election the subsidiary will obtain the advantage of not paying ACT in respect of the relevant dividend. Another consequence is that the subsidiary will obtain this advantage at the cost of depriving the parent of a tax credit in respect of the dividend. These two fiscal consequences are inextricably linked. You cannot have one without the other. That is why the election has to be made jointly. The advantage to the paying subsidiary comes at a price to the recipient parent."*

[942] ECJ 8 March 2001, Joined Cases C-397/98 and 410/98, *Metallgesellschaft*, paras. 46-56.

[943] When *Metallgesellschaft* was decided, ACT had been abolished in the U.K. As a result, it was not necessary to determine how to give effect to the decision for the future.

The House of Lords therefore held that the U.K. regime at issue did not constitute discrimination contrary to the ownership non-discrimination clause of the relevant tax treaties.

2. Analysis
a. 'Similar' does not refer to the shareholder's residence

There are several interesting aspects to this case. First, the decision supports the position taken above, that the correct comparison under Art. 24(5) is with a resident company owned or controlled by another **resident** (see supra). In other words, the term 'similar' does not imply that the object of comparison is a resident company the capital of which is owned or controlled by another non-resident.

b. Discrimination on the basis of foreign ownership

The House of Lords also confirms that Art. 24(5) only concerns discrimination on the basis of foreign ownership. Support for that conclusion was found in the Commentary on Art. 24(1), which states that the expression 'in the same circumstances' implies that the underlying question is whether two residents are being treated differently **solely** by reason of having a different nationality[944]. The Lords acknowledge that this observation is not repeated in relation to Art. 24(5), but they hold that *"the principle must be the same"*.

It is unfortunate that the House of Lords does not address in detail **why** Art. 24(5) should be considered as relating specifically to discrimination on the basis of foreign ownership. Clearly, the mere statement that *"the principle must be the same"* as under Art. 24(5) is not a valid argument. Before 2008, both positions could be defended in theory. On the one hand, it could be argued that Art. 24(5) does not contain the expression 'in the same circumstances', meaning that the interpretation given to that expression in the context of Art. 24(1) cannot be transposed to Art. 24(5). Under that interpretation, the term 'similar' in Art. 24(5) only refers to a resident company the capital of which is owned or controlled by another resident. Consequently, Art. 24(5) applies if the foreign-controlled company is taxed less favourably than a domestically-owned enterprise, regardless of whether there are other reasons for that different treatment than the foreign control[945].

On the other hand, it could also be argued that Art. 24(5) has a very specific purpose, namely to prohibit discrimination against foreign-owned companies. As a result, the provision should not be applied where a measure discriminates on another basis when that measure, coincidentally, also affects foreign-owned companies. Take, for instance, the example of a certain industry that is very dependent on foreign capital. If a domestic tax measure treats that industry less favourably than other industries, it will mainly affect foreign-owned companies. Can a foreign-owned company that is active in that industry invoke Art. 24(5) in order to remove the disadvantage? If it is assumed that 'similar' only refers to a resident company the capital of which is owned or controlled by another resident, there is discrimination contrary to Art. 24(5) since a foreign-owned company is treated less favourably than a domestically-owned company. However, Art. 24(5) was never intended to cover that type of discrimination. Indeed, the history of this provision points out that it was included in the OEEC Draft

[944] Comm. OECD on Art. 24, para. 8. This was before the 2008 update, which made a similar clarification as regards Art. 24(5); see 2.F.I.C.
[945] B. CLEAVE, "Boake Allen and others v HMRC – group income elections and non-discrimination", *B.T.R.* 2007, 606; B. CLEAVE, "Boake Allen (or NEC Semi-Conductors): non-discrimination, advance corporation tax, tax treaties and the free movement of capital", *European Taxation* 2008, 94-95.

specifically to cover discrimination **on the basis of** foreign ownership[946]. Given the purpose and the history of the provision, I prefer the latter intepretation.

That being said, the situation has been clarified by the 2008 update of the Commentary. As pointed out in 2.F.I.C, the Commentary now states that Art. 24(5) discrimination is only concerned with discrimination **on the basis of** foreign ownership. The 2008 update has also included the following example in the Commentary on Art. 24(5). A State levies a tax on resident companies that distribute dividends to their shareholders regardless of whether or not they are residents or non-residents. However, in order to avoid a multiple application of that tax, it does not apply to distributions made to related resident companies that are themselves subject to the tax upon their own distributions.

The fact that the latter exemption does not apply to distributions to non-resident companies does not violate paragraph 5. In that case, *"it is not because the capital of the resident company is owned or controlled by non-residents that it is treated differently; it is because it makes distributions to companies that, under the provisions of the treaty, cannot be subjected to the same tax when they re-distribute the dividends received from that resident company. In this example, all resident companies are treated the same way regardless of who owns or controls their capital and the different treatment is restricted to cases where distributions are made in circumstances where the distribution tax could be avoided."*

It seems that example was directly inspired by the *Boake Allen* case[947]. By expressly providing that the discrimination must be on the basis of foreign ownership, the Commentary now takes a clear position on this issue.

While I agree with the position that Art. 24(5) only concerns discrimination on the basis of foreign ownership, there is an additional issue to be addressed. In the *Boake Allen* case (and in the example given in the 2008 update), the discrimination was not on the basis of foreign ownership but on the basis of the fact that a non-resident parent is not subject to the same tax as a resident parent. However, that element is closely interwoven with the parent's non-residence. Indeed, it could be argued that the non-resident parent is not liable to that tax precisely because it is a non-resident. As a result, distinguishing on the basis of the parent not being liable to the distribution tax is exactly the same as distinguishing on the basis of the parent not being a resident.

To summarize, I agree with the statement now included in the Commentary that Art. 24(5) is only concerned with discrimination on the basis of foreign ownership. However, the Commentary also suggests that distinguishing on the basis of the parent company's non-liability to the distributing tax is not the same as distinguishing on the basis of the parent company's non-residence. That idea requires some further attention (see hereafter).

---

[946] See FC/WP4(57) 2, 7: *"The Swiss Delegation has proposed that in the draft Article there be inserted the following provision which is designed to prevent discrimination* ***on the ground that*** *an enterprise of one country is controlled by persons domiciled in another country: […]"* (emphasis added).

[947] S. BRUNS, "Taxation and non-discrimination: clarification and reconsideration by the OECD", *European Taxation* 2008, 484.

c. 'Similar' may refer to the shareholder's position[948]

The House of Lords decides that there is no discrimination because the measure at issue does not distinguish on the basis of foreign ownership, but on the grounds that a non-resident parent company is not liable to ACT. As an example, the House of Lords refers to the situation where the non-resident parent interposes a U.K. resident holding company between itself and the U.K. resident subsidiary. In such a situation, the control would remain with the non-resident parent but the subsidiary would nevertheless be entitled to make a joint election with its immediate U.K. resident parent. From that, the House of Lords derives that the distinction is not on the grounds that the capital of the subsidiary is controlled by a non-resident.

However, that example seems to be beside the point. Art. 24(5) prohibits less favourable treatment on the grounds that the capital is **owned or controlled** by a non-resident. Those are not cumulative conditions. In the example given by the House of Lords, the capital may very well be controlled by the non-resident partner, but the fact remains that it is owned directly by a resident (i.e. the intermediate parent). In other words, even though it is clear that there is no discrimination on the basis of the non-residence of the person **controlling** the capital, it is still possible that there is discrimination on the basis of the non-residence of the person **owning** the capital. As a result, that example does not prove that the U.K. rule at issue is consistent with Art. 24(5).

The more appropriate approach would be to compare the treatment of the subject of comparison (i.e. a resident subsidiary of a non-resident parent) with that of the correct object of comparison. In this respect, the correct object of comparison is a **similar** resident company the capital of which is owned or controlled by a resident. As pointed out above, 'similar' implies that **all relevant elements**, apart from the non-residence of the shareholder, must be identical. Accordingly, the decisive question is whether the liability to ACT of a resident parent company is a relevant element in this regard. If that is the case, then the resident subsidiary of a non-resident parent is not similar (and, therefore, not comparable) to the resident subsidiary of a resident parent, since the non-resident parent is not liable to ACT while the resident parent is. Since the election regime is a joint decision by the companies involved that one rather than the other will be liable for ACT, it seems clear at first glance that the question as to whether the parent company is liable to ACT is relevant in the context of this regime.

The problem, of course, is that the liability to ACT is linked with the liability to corporation tax, since ACT is an advance payment of that corporation tax. And, in turn, the liability to corporation tax is a direct consequence of being a resident in the U.K. As discussed earlier, elements that are inextricably linked with the comparative attribute (which, in the present case, is the shareholder's non-residence) should be left out of the comparability-analysis. It is therefore necessary to ascertain whether the shareholder's liability to ACT is inextricably linked with that shareholder's place of residence.

[948] As pointed out above, the term 'similar' does not add anything substantial to the interpretation of Art. 24(5). It merely stresses that all relevant elements, apart from foreign ownership, should be identical. For the sake of readability, it is implied here that that requirement follows from the interpretation of the term 'similar', but it should be kept in mind that it is already inherent in the provision because its scope of application is limited to discrimination on the basis of foreign ownership.

> In *Boake Allen*, the distinction was not made on the basis of the comparative attribute, but on the basis of a characteristic that is related thereto. That is to say, instead of distinguishing on the basis of the parent's non-residence and then arguing incomparability on the basis of the parent's non-liability to ACT, the distinction is made directly on the basis of that parent's non-liability to ACT. As discussed in Part I, B.II, that does not affect the discrimination analysis. Distinguishing on the basis of a characteristic other than the comparative attribute is exactly the same as distinguishing on the basis of the comparative attribute and then arguing that the situations are rendered incomparable because of that characteristic. Consequently, this element should be considered in the comparability-analysis[949].
>
> It is therefore necessary to determine whether the characteristic in question (i.e. the parent company's liability to ACT) is inextricably linked with the comparative attribute (i.e. the parent company's residence). If that is the case, it should be left out of the analysis, meaning that it does not render the situations incomparable.

All of this implies that there are two separate questions. <u>The first question</u> is whether the tax position of the parent company is **relevant** from the perspective of the domestic measure at issue. If it is, it should be taken into consideration when determining what a 'similar' resident company is. Applied to the present case, if the parent company's liability to ACT is relevant from the perspective of the group election regime, that means that resident subsidiaries of non-resident parent companies are not comparable to resident subsidiaries of resident parent companies. Consequently, denying the group election regime to the former does not constitute discrimination. <u>The second question</u> is whether, if the parent's tax position is relevant, that tax position is inextricably linked with the comparative attribute. If that is the case, it should be left out of the analysis. Applied to the present case, if the parent company's liability to ACT is inextricably linked with its residence, that element should be left out of the analysis even though it is relevant from the perspective of the group election regime. That would mean that denying the group election regime to resident subsidiaries of non-resident parent companies constitutes discrimination because there is nothing that renders them incomparable (assuming that no other grounds for incomparability are brought forward).

In order to apply these principles to the present case, it should first be recalled that the ACT regime had two functions. **(1)** On the one hand, payment of ACT by the distributing company meant that the recipient of the dividend was entitled to a tax credit corresponding to the amount of ACT paid. Once ACT had been paid, the profit could pass through a chain of companies without attracting further liability to tax. From that perspective, the payment of ACT was intended to ensure that the profit is taxed only once in the chain of distributions. The group election regime was a specific modality of that regime, which allowed the ACT liability to be transferred to another link in the chain.

(1a) With respect to that function, it is undeniably true that the tax position of the shareholder is relevant for the group election regime, since that regime cannot be meaningfully applied where the shareholder is not liable for ACT. It would indeed be absurd to allow ACT liability to be transferred to another party if that other party is not liable to ACT. Therefore, the answer to the first question is in the affirmative as regards this first function. As a result, resident subsidiaries of non-resident parent companies can be considered incomparable to resident subsidiaries of resident parent companies.

As to the second question, it seems that the shareholder's liability to ACT is not inextricably linked to his residence. Indeed, there are also **residents** who are **not** liable for ACT, for

[949] See the flowchart in Part I, B.II.

instance individual shareholders. Therefore, the parent's non-liability to ACT can be seen as a criterion which is distinct from its non-residence. As a result, the distinguishing criterion used by the U.K. rule cannot be equated to foreign ownership.

In conclusion, even though a resident company that is owned or controlled by a non-resident shareholder is unable to elect while a resident company that is owned or controlled by a resident shareholder is able to do so, that distinction does not constitute discrimination because both situations are not comparable. In the latter situation, the non-resident shareholder is not liable to ACT while the resident shareholder in the former situation is[950]. Since that is a relevant characteristic which is not inextricably linked with the comparative attribute, the situations are not comparable.

Since the non-resident shareholder's absence of ACT liability is a relevant characteristic, the correct object of comparison is a resident company owned or controlled by a resident shareholder that is identical to the subject of comparison in all relevant aspects, including the absence of liability to ACT at the shareholder level. If I understand the U.K. regime correctly, that will only be the case if the shareholder is a resident individual or an incorporated charity[951]. In those cases, the resident company will not be able to elect either. Consequently, since there is no similar resident company that is treated more favourably than the subject of

[950] Of course, it is possible in practice that a resident parent company will not actually pay ACT because it does not distribute any dividends or because it makes a distribution under the election regime which would otherwise have been liable to ACT (the liability then being shifted to the recipient as a result of the election). However, that does not change the fact that the resident parent falls within the scope of application of the ACT and is therefore liable to ACT.

[951] In *FCE Bank* (which will be discussed in 2.F.II.D.h), the First-Tier Tribunal gives a schematical overview of the possible objects of comparison in *Boake Allen*: "*We summarise our understanding of Lord Hoffmann's approach as follows:*

Type of ownership	**Residence of recipient of dividend**	**Group income election possible**	**Whether recipient liable to pay ACT on payment of a dividend**
Direct, company (the situation in the case)	US	No	No
Direct, company	UK	Yes	Yes
Indirect, non-resident company (as to the dividend between the UK sub-subsidiary and subsidiary)	UK	Yes	Yes
Direct, individual	UK	No	No
Direct, individual	US	No	No

The table shows the exact concurrence between liability to pay ACT and the ability to make a group income election, which is different from the residence of the recipient. Therefore it clearly shows that the ground for the difference in treatment was the recipient's liability to pay ACT. Therefore the alleged discrimination was not prevented by the Treaty provision.

We believe that there is a further situation, which is particularly relevant as it concerns a corporate shareholder, that supports the argument, where the owner of the shares is an incorporated charity resident in the U.K.:

Direct, incorporated charity	UK	No	No

The significance of the examples is therefore to show that the real ground of the difference in treatment was the liability of the recipient to pay ACT, and the residence of the owner in the situation under appeal was not the real ground. The examples of the individual owner (and also the charity) demonstrate that the liability to pay ACT is not equivalent to the residence of the owner, although it would be if only company recipients were considered" (First-Tier Tribunal (Tax) 24 March 2010, *FCE Bank Plc v Revenue and Customs Commissioners,* 2010 *UKFTT* 136 (TC), paras. 14-17).

comparison, there is no discrimination[952]. In this respect, the decision of the House of Lords is therefore correct.

> As discussed earlier, the application of a non-discrimination rule that prohibits discrimination on a given basis, such as Art. 24(5)[953], can be approached in two ways. Either one ascertains whether the distinction is made on the basis of the prohibited criterion (by determining whether there are situations where the benefit at issue is denied even though that criterion is not present), or one first constructs the subject and object of comparison by defining all relevant characteristics, apart from the prohibited criterion.
>
> As submitted above, the second approach is preferable. That being said, the facts in *Boake Allen* illustrate that both approaches ultimately lead to the same result. In the preceding paragraphs, the second approach was applied. In particular, the subject and object of comparison were constructed by combining all relevant characteristics (including the shareholder's liability to ACT). This analysis shows there is no discrimination contrary to Art. 24(5) because there is no comparable object of comparison that is treated more favourably than the subject of comparison.
>
> The first approach consists of determining whether the distinction was made on the basis of foreign ownership. At first sight, that is not the case since the distinction is made on the basis of the shareholder's liability to ACT. However, it is necessary to determine whether that amounts to the same thing as distinguishing on the basis of foreign ownership. In order for a person to be liable to ACT, it is necessary to be a company **and** to be a U.K. resident. So the benefit at issue (the group election regime) is denied if the shareholder is not a company **or** if he is a non-resident. For instance, the benefit would also be denied if the shareholder is a resident individual. This analysis demonstrates that the basis on which the distinction is made (liability to ACT) does not coincide with the prohibited criterion (foreign ownership)[954].

(1b) The above analysis is made under the assumption that the nature of the shareholder as a company is not a relevant characteristic. In other words, it is assumed that the appropriate subject of comparison is a resident company the capital of which is owned or controlled by a non-resident shareholder, regardless of whether that shareholder is a company or not, and the appropriate object of comparison is a resident company the capital of which is owned or controlled by a resident shareholder, regardless of whether that shareholder is a company or not.

However, it could also be argued that the question whether the shareholder is a company is a relevant characteristic for purposes of the measure under scrutiny. In that case, the comparison is between the resident subsidiary of a non-resident parent company and the

---

[952] See also P. BAKER, "Review of recent treaty cases – NatWest II, NEC and SA Andritz", *Bull. IBFD* 2004, 209: "*In truth, there was no real comparator with the situation of a Japanese resident parent and a U.K. resident subsidiary when one looks broadly at the issue of group income and the payment of ACT: a U.K. resident parent company receiving a dividend under a group income election would have to pay ACT if it subsequently paid on a dividend; no non-resident parent would have to do so.*"

[953] As opposed to a non-discrimination rule that guarantees that the subject of comparison is entitled to a treatment that is not less favourable than the treatment accorded to the object of comparison, regardless of whether the distinction is made on the basis of a specific criterion.

[954] Compare this to the *Delaware* case, discussed in 2.F.III.B.a, where the benefit at issue (being entitled to qualify as an Organträger) was granted to residents **or** to non-residents with a PE in Germany. So the benefit was denied if the shareholder was a non-resident **and** that non-resident did not have a PE in Germany. There, it is clear that the distinction is made on the basis of foreign ownership since foreign ownership is a necessary precondition for the benefit to be denied (i.e. there are no cases in which the benefit is not granted even though the prohibited criterion is not present).

resident subsidiary of a resident parent company. If that is the proper comparison, it seems clear that liability to ACT is inextricably linked with residence: non-resident parent companies are never liable to ACT, while resident parent companies are. For that reason, liability to ACT should be left out of the analysis[955].

The result of the comparability-analysis would then be that the resident subsidiary of a non-resident parent company is comparable to the resident subsidiary of a resident parent company. The analysis thus shifts to the disadvantage-test.

The argument could then be that this first function of ACT is concerned with the payment of the dividend to the shareholders rather than with the taxation of the resident enterprise. In other words, ACT functions as a sort of withholding tax[956]. As discussed above, Art. 24(5) is only concerned with the taxation of the enterprise itself, and not with the taxation of the capital in the hands of the non-resident shareholders. Since it is the non-resident shareholder and not the subject of comparison that incurs a disadvantage, there is no discrimination.

However, the group election regime allowed the ACT liability to be shifted to another party. Denying that possibility quite clearly constitutes a disadvantage for the resident subsidiary. For that reason, it would be difficult to argue that the group election regime constitutes 'taxation of the shareholder' rather than taxation of the resident company.

As an alternative approach to the disadvantage-test, it could be argued that this function of the group election regime does not amount to the mere granting of a tax benefit to one taxpayer in particular, but instead inherently concerns the group as a whole. Since its purpose was precisely to shift liability to ACT from one company to the other, it is necessary to consider the effects of that regime on the group as a whole. If a resident subsidiary makes a group election together with its resident parent, the result is that the ACT is due once, whether it be at the level of the parent or at a subsequent level (when the parent, in turn, elects together with the subsequent company in the chain of distributions). If the election is refused to a resident subsidiary because its parent company is a non-resident, the ultimate effect will be that ACT is due only once: at the level of the resident subsidiary. So ultimately, there is no disadvantage for the group as a whole. Whether the parent company is a resident or not, ACT will only be due once. But the reason why the election regime is refused where the parent is a non-resident is that ACT cannot be collected from the parent in that case. For that reason, the group as a whole is required to pay ACT at the level of the resident subsidiary[957].

(2) ACT also has a second function. For the distributing company, the ACT paid functions as a prepayment for MCT. From that perspective, the group election regime merely means that

[955] Similarly: B. CLEAVE, "Boake Allen and others v HMRC – group income elections and non-discrimination", *B.T.R.* 2007, 606: *"Although it is true that the inability of an enterprise controlled by a non-resident to join its parent company in making a group income election is because the parent is not liable to pay ACT in respect of the dividends to its shareholders, the reason that it is not so liable is because it is non-resident. The argument at this point is therefore circular […]"*.

[956] However, the U.K. tax authorities would have been reluctant to put this argument forward since they have always rejected the characterisation of ACT as a withholding tax on dividends; see J. OLIVER, "Other similar enterprises – NEC Semi Conductors Ltd and others v Inland Revenue Commissioners", *B.T.R.* 2004, 83.

[957] Support for this interpretation can be found in the House of Lords decision in *Boake Allen*, where it is stated that *"it is not possible to decouple the positions of parent and subsidiary […]. To allow an election by a group with a U.S. resident parent would not be to give a relief available to a group with a U.K. resident parent. It would be something different in kind. It would not be an election as to who would be liable for ACT but as to whether the group should pay it at all"* (House of Lords 23 May 2007, 9 ITLR 995, para. 19 and see supra).

the distributing company enjoys a cashflow advantage, in that it is not required to pay a proportion of MCT directly but instead can wait until MCT falls due[958]. That cashflow advantage is an advantage for the distributing company (i.e. the resident subsidiary) separately, irrespective of any benefits for the group as a whole. And for the purposes of that benefit, the tax position of the shareholder is irrelevant. It is perfectly possible to allow the resident company controlled by a non-resident shareholder to wait until the MCT falls due to pay the entire amount instead of requiring immediate payment of a proportion thereof when profits are distributed to the non-resident shareholder.

From that perspective, there is no connection between the non-resident shareholder's non-liability to ACT and the benefit granted to the subsidiary under the group election regime (i.e. the subsidiary's entitlement to delay the payment of a proportion of MCT). As a result, the shareholder's tax position is irrelevant and should not be taken into account when considering the comparability as regards this function of ACT. The fact that the non-resident shareholder is not liable to ACT therefore does not lead to incomparability. In the absence of other reasons for incomparability, the refusal of the cashflow advantage should therefore be considered to constitute discrimination[959].

The fact that the U.K. system has joined these two functions in one regime does not affect this conclusion. The prepayment of corporation tax upon distribution of profits has nothing to do with the avoidance of double taxation of that distribution in the hands of the recipient. When the regime is held to be discriminatory with respect to the possibility to forego the prepayment of MCT, that does not mean it is also discriminatory with respect to the possibility to transfer ACT liability to another company. That is to say, non-discrimination is merely a tool to uncover certain flaws in a tax system. It is up to the legislator to correct those flaws. If a measure, which is integrated in a broader regime, is found to be discriminatory, that does not mean that the regime as a whole is discriminatory. The legislator may choose to adapt that regime so that the discriminatory feature is removed, or abolish the regime altogether (perhaps replacing it with a less flawed version).

d. The ECJ's approach

The final interesting aspect of *Boake Allen* is that the exact same issue was addressed by the ECJ in *Metallgesellschaft*. This aspect will be discussed in Part III, 2.E.b.5.a and Part IV, 1.A.IV.B.

e. DaimlerChrysler India[960]

1. The decision of the ITAT

The taxpayer in this case was the Indian subsidiary of DB, a German company. DB held 81% of the shares in the Indian subsidiary. In 1999, the German parent company merged with a

---

[958] That is also the position taken by the ECJ in *Metallgesellschaft* with respect to the U.K. regime; see Part III, 2.E.b.5.a.

[959] With respect to this second function, the same conclusion would be reached if the status of the shareholder as a company is considered relevant for the purpose of the measure at issue (see supra, the distinction between 1a and 1b). In that case, liability to ACT would have to be disregarded because it is inextricably linked with the comparative attribute. Since there are no other reasons for incomparability, the situations should be considered comparable. As to the disadvantage-test, it is clear that the cash-flow disadvantage discussed here is a disadvantage to the resident subsidiary itself. There is no reason to consider the group as a whole in this regard.

[960] Indian Income Tax Appellate Tribunal, Pune B Bench, 21 January 2009, *DaimlerChrysler India Private Limited v Deputy Commissioner of Income Tax*, ITA No. 698/PN/03, 11 *ITLR* 811.

U.S. company, as a result of which a new company, DC, was formed in Germany. As a result of the merger, all of DB's assets, including the shareholding in the Indian subsidiary, were transferred to the new company DC.

Under Indian domestic tax law, an Indian company was unable to carry forward its losses if more than 51% of its shares were transferred. That restriction did not apply if its parent company's shares were listed on a stock exchange in India. The question arose whether that distinction fell foul of the ownership non-discrimination provision of the German/Indian treaty[961].

The Indian Income Tax Appellate Tribunal (ITAT) first noted that only resident companies could be listed in India. As a result, an Indian subsidiary of a non-resident company would always be treated less favourably as regards the possibility to carry forward losses after a merger involving the parent company.

The ITAT therefore went on to determine what a 'similar' enterprise was. In particular, it inquired whether the proper comparison was with a resident company with a non-resident parent or with a resident company with a resident parent. For that purpose, the ITAT considered a number of decisions on this issue by foreign courts[962]. In particular, the ITAT refers to the *Delaware* case (see 2.F.III.B.a), *UnionBanCal* (see 2.F.II.D.f) and *SA Andritz* (see 2.F.IV.B.a) and notes that, in all of those cases, the comparison was made with a **domestically-owned** company.

On the other hand, the ITAT observes that *Boake Allen* (see supra) supported a different conclusion. In that respect, the ITAT quotes the House of Lords' statement that the Commentary on Art. 24(5) does not repeat the statement made in relation to Art. 24(1) that the underlying question is whether two residents are being treated differently solely by reason of having a different nationality, but that *"the principle must be the same"*. On the basis of that statement, the Court concludes as follows: *"what is to be seen is that the differentiation between two residents is on the grounds of nationality. In other words, therefore, when, for the purposes of art 24(5), differentiation in treatment is examined […] the differentiation is to be examined vis-à-vis another resident with foreign capital and not with another resident with domestic capital. It is only in such a situation that the differentiation on the grounds of nationality, which is underlying thrust of art 24(1), could be relevant"*[963].

According to the ITAT, the approach taken by the House of Lords is questionable because Articles 24(1) and 24(5) OECD MC have a different basis and different purposes. While the former seeks to ensure that no discrimination takes place on the basis of a taxpayer's nationality, the latter seeks to ensure that investment of foreign capital is not made less advantageous for the entity in which the capital is invested. For that reason, the ITAT does

[961] Art. 24(4) of the 1995 Germany / India treaty, which is identical to Art. 24(5) OECD MC.
[962] In this context, the Court makes an interesting observation. It points out that, because of the authoritative value of the OECD MC, tax treaty provisions are often uniform among different States. For that reason, is is useful to take account of foreign court decisions when interpreting a treaty provision. In order to ensure a harmonious interpretation of those provisions, it is desirable to conform to the majority opinion expressed in those decisions. However, if there is a divergence of judicial opinions in those foreign decisions, it is necessary to ensure that the interpretation given to a certain treaty position is in accordance with the interpretation given to that provision by the courts of the other contracting State of that specific treaty (see ITAT, *DaimlerChrysler India*, paras. 56-59).
[963] ITAT, *DaimlerChrysler India*, paras. 79-81.

not agree with the position that the underlying question in Art. 24(5) is also whether there is discrimination on the basis of nationality[964].

Consequently, the ITAT compares the treatment of the taxpayer in the case at hand (i.e. the Indian subsidiary of a German company) to that of an Indian subsidiary of an Indian company. Since an Indian subsidiary of an Indian parent company the shares of which were listed on a stock exchange in India was entitled to carry forward its losses, while an Indian subsidiary of a German parent company the shares of which were listed on a stock exchange in Germany was not entitled to do so, the ITAT held that the measure infringed the ownership non-discrimination provision.

The ITAT then refers to its position taken in *Automated Securities Clearance* (see 2.D.III.C.a.3). However, the distinction was held to be unreasonable in the present case. Moreover, even if the distinction was reasonable, it was not certain that the conclusion reached in *Automated Securities Clearance* could be transposed, as that case was decided in the context of the tax treaty with the U.S., "*in which differentiation on the ground of reasonableness is institutionalized in the treaty and the Technical Explanation*".

Since the records did not indicate whether the German parent was listed on a stock exchange in Germany, the ITAT referred the matter to the tax authorities in order to determine whether that was the case. Therefore, the Court held that the loss carry-forward had to be allowed if the tax authorities found that the Germany company was indeed listed in Germany.

2. Analysis

1. The distinction was not on the basis of the comparative attribute

The distinction in the present case was not made on the basis of the parent company's residence, but on the basis of whether that parent was listed on a stock exchange in India. Because only resident companies could be so listed, the Court equated that distinction to a distinction on the basis of foreign ownership. As pointed out above, that should not affect the discrimination analysis. This issue should be taken into account in the comparability analysis. That is to say, the first question in the discrimination-analysis should always be whether a distinction was made. Clearly, that was the case here. Next, it must be determined whether the situations between which a distinction was made (i.e. the taxpayer and the object of comparison), are comparable. For that to be the case, all relevant characteristics apart from foreign ownership must be identical. The question thus arises whether being listed on a stock exchange in India is a relevant characteristic in light of the measure at issue.

According to the ITAT, that characteristic was apparently relevant. Indeed, the Court made a comparison between the Indian subsidiary of an Indian parent company that was listed in India and the Indian subsidiary of a German company that was listed in Germany. The ITAT thus accepts that the relevant characteristic, i.e. the shares of the parent company being listed, was identical among subject and object of comparison. Since the latter was entitled to the loss carry forward, while the former was not, the ITAT held that there was discrimination. However, it is unclear to me why being listed is a relevant characteristic in the light of the possibility to carry forward losses. Perhaps companies that are publicly listed in India are considered to be less likely to engage in loss-trading transactions? But even if that is the case, that does not explain why parent companies listed in India are comparable to parent

[964] ITAT, *DaimlerChrysler India*, paras. 85-86.

companies listed in Germany[965]. In any event, the decision would have gained in clarity if the ITAT had explained why it considered that characteristic relevant for the measure at issue.

2. The ITAT's reading of Boake Allen

Apparently, the ITAT misunderstood the statement in *Boake Allen*, which was quoted above. According to the ITAT, that statement implied that the House of Lords considered Art. 24(5) to require different treatment on the basis of nationality. From that, the ITAT inferred that the House of Lords meant that the proper comparison under Art. 24(5) is between a resident subsidiary owned by a parent company of the other contracting State and a resident subsidiary owned by another non-resident parent company[966].

But that is not what the House of Lords was saying. As discussed above, the statement in question supported the conclusion that Art. 24(5) concerns rules that discriminate **solely** on the basis of foreign ownership. That is the analogy drawn between Art. 24(1) and Art. 24(5). Unfortunately, the ITAT understood the analogy to mean that Art. 24(5) is also concerned with discrimination on the basis of nationality, which, clearly, it is not[967].

f. UnionBanCal

1. The decision of the Tax Court and the Court of Appeals

The taxpayer, a U.S. company, sold a loan portfolio to its U.K. parent company in 1984, realizing a significant loss. Under U.S. tax law at the material time, losses from a sale between members of the same group were deferred until the property in question was transferred outside the group. If the selling member left the group before the property was transferred outside the group, the taxable basis of the purchasing member was adjusted. More specifically, the purchasing member's basis in the property was increased by the amount of the selling member's deferred loss[968].

Consequently, the U.S. subsidiary was unable to deduct the loss from the sale in 1984, since it had sold the loan portfolio to another member of the group. Instead, the losses associated to the sale had to be deferred. In 1988, the taxpayer left the group, which still held the loan portfolio. The taxpayer requested to deduct the remaining losses in 1988, but the U.S. tax authorities dismissed that claim.

As pointed out above, the purchasing member, i.e. the U.K. parent, could take the deferred loss as a stepped-up basis in the portfolio. However, the British tax authorities did not recognize that stepped-up basis for U.K. tax purposes. The taxpayer requested the competent

---

965 See also B. ARNOLD, "Tax treaty news", *Bull. IBFD* 2009, 271.

966 The ITAT does not clarify whether the latter parent company should also be resident of the other contracting, or a third State. It merely points out that *"the differentiation is to be examined vis-à-vis **another resident with foreign capital** and not with another resident with domestic capital"* (ITAT, *DaimlerChrysler India*, paras. 81; emphasis added).

967 See also J. AVERY JONES, "Letter from John Avery Jones regarding the Tax Treaty Monitor, Tax Treaty News, July 2009 on the case of DaimlerChrysler India Private Limited", *Bull. IBFD* 2009, 494.

968 The advantage for the purchasing member is that the capital gain realized upon transfer of the property outside the group will be taxed on the basis of the price of purchase plus the deferred loss. Assume that a company has shares that are worth 100 and sells them to a member of the same group for 80. The rules at issue here prevent the loss of 20 from being taken into account. Consequently, the seller is unable to deduct that amount of 20. On the other hand, when the purchasing member sells the shares to an unrelated party for 110, he will not be taxed on a capital gain of 30, but on a capital gain of 10 (i.e. the purchasing member's basis is increased by the seller's deferred loss, meaning that the capital gain is calculated on a basis of 100 instead of 80).

U.K. and U.S. authorities to resolve this inconsistency, but they failed to reach an agreement. The U.S. would not withdraw its refusal to grant the taxpayer the loss deduction while the U.K. would not allow the U.K. parent to increase its basis in the loan portfolio to reflect the loss disallowed the taxpayer for U.S. tax purposes.

The taxpayer argued that the refusal to take the losses into account in the U.S. constituted discrimination contrary to the ownership non-discrimination clause in the U.K./U.S. treaty[969]. In particular, losses sustained by subsidiaries of non-residents were denied unless the competent authorities of the U.S. and the other State reached an agreement so as to allow the losses to be taken into account. In contrast, a U.S. company with a U.S. parent entirely avoided this requirement of competent authority intervention. For that reason, the taxpayer argued that the requirements imposed on a foreign-owned resident were more burdensome than those imposed on a domestically-owned resident.

The U.S. Tax Court dismissed the taxpayer's claim[970]. The Tax Court held that the U.S. tax rules at issue made no distinction on the basis of the place of residence of the taxpayer's parent company, but rather on the taxpayer's selling property at a loss to members of the same group. A U.S. resident with a U.S. parent would face the same burdens and requirements as the taxpayer in the present case if it sold property at a loss to a U.K. resident that was a member of the same group. Conversely, a U.S. resident with a U.K. parent might sell property to a U.S. resident that is a member of the same group. The Tax Court therefore held that the taxpayer's problem did not arise under U.S. tax law but under U.K. tax law, which has not given effect to the increase in the U.K. parent's basis as provided for under U.S. tax law. According to the Tax Court, *"the failure of the competent authority process to resolve this inconsistent treatment under U.S. and U.K. tax laws is unfortunate, but it does not reflect upon the validity of"* the U.S. rules at issue.

The Tax Court's decision was confirmed by the Court of Appeals[971]. The Court of Appeals held that the taxpayer did not show that the U.S. imposed more burdensome taxation or requirements on U.K-owned subsidiaries than U.S.-owned subsidiaries. According to the Court of Appeals *"it was merely fortuitous that, because the British and American tax authorities could not agree on how to recognize the deferred loss, [the taxpayer and its U.K. parent] were worse off than if they had been entirely of one country or the other."* The Court of Appeals acknowledges that the taxpayer never got tax recognition of its loss on the sale of the loan portfolio to the U.K. parent because of the U.S. tax rules at issue, but *"it hasn't shown that it would have been treated any differently had [the U.K. parent] been American. It would have been treated the same. And discrimination against foreign-owned subsidiaries is all that the nondiscrimination clause at issue protected it against."*

2. Analysis

Apart from confirming that the proper comparison is with a domestically-owned company (see supra), this case is mainly interesting because it is concerned with the question whether the distinction was made **on the basis of** the comparative attribute. Both the Tax Court and the Court of Appeals decide in this respect that the distinction was not made on the basis of the parent company's place of residence. Instead, the distinction was made on the basis of the

[969] Art. 24(5) of the 1975 U.K. / U.S. treaty, which is identical to Art. 24(5) OECD MC.
[970] Tax Court 22 October 1999, No. 11364-97, *UnionBanCal Corporation v Commissioner of Internal Revenu*e, 113 *T.C.* 309.
[971] United States Court of Appeals, Ninth Circuit, No. 00-70764, 18 September 2002, 305 *F.3d* 976.

place of residence of the purchasing member of the group. If the purchasing member was a non-resident, the taking into account of losses required the competent authorities to intervene, regardless of whether that purchasing member was the parent company of the selling member.

In other words, this is a matter of constructing the appropriate subject and object of comparison. The subject of comparison is a U.S. company with a U.K. parent that sells property at a loss to a non-resident group member. The object of comparison is a U.S. company with a U.S. parent that sells property at a loss to a non-resident group member. Since both situations are treated identically, there is no discrimination contrary to the ownership non-discrimination clause. The issue was somewhat confounded because, in the case at hand, the purchasing member was at the same time the parent company of the selling member, but, clearly, that was not a relevant characteristic in light of the measure at issue. Accordingly, it should not be taken into consideration when constructing the object of comparison.

The analysis could have stopped there. Since both the subject and the object of comparison incur the same disadvantage (i.e. the necessity that the competent authorities intervene in order to allow the loss being taken into account), there was no discrimination. However, both courts also address the actual **reason** for that disadvantage. Since that is an element of the disadvantage-test, it should only be assessed after the comparability-test. Strictly speaking, therefore, that aspect should not have come up for discussion at all. As to the substance of the courts' arguments in this respect, it is interesting that they both seem to conclude that there was no discrimination because the disadvantage was not **due to** the measure at issue but rather due to a failed attempt by the competent authorities to reach a mutual agreement. I do not find that very convincing. From the perspective of the compatibility of the U.S. rules at issue with the tax treaty, the problem was not that the U.K. and the U.S. failed to reach an agreement in this instance, but rather that it was required for them to reach an agreement to begin with. Had the property been transferred to a resident, no such agreement would have been necessary. That was the disadvantage at issue. And that disadvantage was clearly due to the U.S. rules at issue. The decisive question would thus have been whether the necessity for the competent authorities to reach an agreement on the tax treatment of the losses constitutes *"other or more burdensome taxation or connected requirements"* within the meaning of Art. 24(5). Given the interpretation of that expression in the context of Art. 24(1), I am inclined to believe that it is[972].

Put briefly, the outcome of the decisions was certainly correct, since the subject of comparison was not treated less favourably than the (properly constructed) object of comparison. However, if the U.S. rules would have made a distinction on the basis of the parent company's place of residence (instead of the purchasing member's place of residence, as they did in the present case), I believe that the outcome would have to be different, since there would have been discrimination contrary to Art. 24(5) in that case.

[972] See supra, 2.B.VI and infra, 2.F.III.

g. Square D[973]

1. The decision of the Tax Court

This case is somewhat similar to *UnionBanCal*, discussed above. At issue was a tax deduction for interest expenses claimed by the U.S. subsidiary of a French company. The U.S. subsidiary, an accrual method taxpayer, accrued but did not pay interest owed to its French parent and to two French sister companies[974]. The U.S. subsidiary claimed deductions of the accrued interest in those years.

U.S. tax law provided for rules on the 'matching' of the deductibility and the payment of interest. Under those rules, interest accrued to related persons could not be deducted until it was actually paid if, by reason of the accounting method used by the recipient of the payment, the amount was not includible in the taxable income until it was paid. Consequently, if a U.S. resident accrual method taxpayer paid interest to a related U.S. resident cash method taxpayer, the payer could not deduct the expense until it was actually paid. In other words, the matching principle required the payer to use the cash method of accounting in deducting such interest expenses.

The same matching principle applied if the recipient of the payment was a related non-resident and if the interest was not income effectively connected with a U.S. trade or business. Conversely, if the interest was effectively connected with a U.S. trade or business, the payer could apply the accrual method in deducting the interest expense if the non-resident recipient used the accrual method of accounting. In the case at hand, the interest payment was not effectively connected with the conduct of a U.S. trade or business.

Applying those rules, the U.S. tax authorities refused the deduction in the year in which the interest was accrued. The taxpayer argued that this refusal constituted discrimination contrary to the ownership non-discrimination clause of the applicable tax treaty[975].

The Tax Court dismissed the taxpayer's claim. After pointing out that the appropriate comparison is with a domestically-owned resident, the Tax Court observes that the ownership non-discrimination clause does not apply *"when there is no connection between the residence of the owners and the different tax treatment that result under U.S. law"*.

According to the taxpayer, there was such a connection, since he was denied an accrual basis deduction for interest amounts owed to its foreign owner, while a hypothetical U.S.-owned company would be permitted accrual basis deductions for interest amounts owed to its U.S. owner (as long as that owner used the accrual method). The Tax Court dismissed that argument and held that the U.S. rules at issue operated independently of the residence of the owners of the payer. According to the Court, the fact that payments to a foreign owner might be treated differently from payments to a U.S. owner was *"merely incidental"*. Instead, the basis for deferring the interest deduction was dependent entirely *"on the U.S. tax treatment of*

[973] U.S. Tax Court, No. 6067-97, *Square D Company and Subsidiaries v. Commissioner of Internal Revenue*, 27 March 2002, 118 *T.C.* 299, confirmed by U.S. Court of Appeals, Seventh Circuit, No. 04-4302, 13 February 2006, 438 *F.3d* 739.

[974] The U.S. tax rules at the material time provided that, generally, corporations with gross receipts of more than \$5 million were required to use the accrual method of accounting. Under that method, a taxpayer must include income and deductions in the taxable year in which the income or liability is fixed and can be determined with 'reasonable accuracy'. Smaller businesses generally used the cash method, under which a taxpayer must include all income and deductions in the taxable year in which they are actually received or paid.

[975] Art. 24(3) of the 1967 French/U.S. treaty, which is identical to Art. 24(5) OECD MC.

the payment in the hands of the foreign corporation, not the identity or nationality of the owner of the payor".[976]

For instance, a U.S. company, whether domestically-owned or foreign-owned, was required to apply the cash method in deducting interest payments to a related non-resident if the interest was not effectively connected with a U.S. trade or business. Furthermore, interest payments that were effectively connected with a U.S. trade or business could be deducted on the accrual method if the non-resident recipient used the accrual method, irresepective of whether the payer was domestically-owned or not. Thus, if a U.S. company made an interest payment to a related non-resident, the accounting method for deducting the amount depended on whether the interest was or was not effectively connected with a U.S. trade or business and on whether the recipient used the accrual method, not on the residence of the owners of the U.S. company. The Tax Court therefore held that there was no discrimination.

2. Analysis

As in *UnionBanCal*, the issue turned on whether the distinction was made on the basis of the comparative attribute. Accordingly, the core issue is the construction of an appropriate subject and object of comparison. Here, the subject of comparison was a foreign-owned resident that paid interest to a related non-resident. The object of comparison was a domestically-owned resident that paid interest to a related non-resident. Since both situations are treated identically, i.e. both are required to apply the cash method in deducting the payment, there is no discrimination.

In other words, the fact that the taxpayer in the present case was unable to apply the accrual method was due to the place of residence of the recipient, rather than that of its parent company. More specifically, because the recipient was not a U.S. resident, an additional condition applied, in that the interest had to be effectively connected with a U.S. trade or business. In the present case, the recipient was, coincidentally, also the parent company, but that does not mean that the U.S. rules at issue were discriminatory: because the fact that the interest was specifically paid to the parent company was not a relevant characteristic, the proper comparison was with a domestically-owned resident that paid interest to a related non-resident (i.e. any related non-resident).

h. FCE Bank[977]

1. The decision of the Tribunal

Under the U.K. group relief provisions at issue in this case, it was possible for a resident company to surrender its losses to another resident company within the same group. One of the companies had to be a 75% subsidiary of the other, or they both had to be 75% subsidiaries of a third resident company.

---

[976] The Court of Appeal would later reach a similar conclusion in its decision in *Square D*: *"The regulation does not impose the cash method simply because of foreign ownership, which would be prohibited, but rather for payments to a foreign related party. Even if a corporation were owned by a United States parent, it still appears all interest payments to one of these foreign related parties would lead to the use of the cash method. The requirement, therefore, hinges on the nationality of the related party to whom the payment goes and does not fluctuate based on nationality of the ultimate owner. It is merely fortuitous that, in this case, the foreign related party to which the payment was made also happened to be the owner. The regulation does not discriminate based on foreign ownership, and thus, does not violate the nondiscrimination clause"* (438 *F.3d* 739, 748).

[977] First-Tier Tribunal (Tax) 24 March 2010, *FCE Bank Plc v Revenue and Customs Commissioners*, 2010 *UKFTT* 136 (TC).

In the case at hand, a U.K. resident subsidiary of a U.S. parent company wanted to transfer losses to another U.K. resident subsidiary ('the accepting subsidiary') of the U.S. parent. Because the parent company was not a resident, the U.K. tax authorities refused the application of the group relief regime. The accepting subsidiary argued that this refusal constituted discrimination contrary to the ownership non-discrimination of the U.K./U.S. treaty[978] because the group relief would have been available if the parent company had been a U.K. resident.

Before the First-Tier Tribunal, the tax authorities argued that the distinction at issue was not based on foreign ownership. If the common shareholder of the two resident companies was a resident **individual**, the losses would not be transferable by way of group relief either. Even though the control of the resident companies would have rested in the U.K. and not in the U.S., group relief would still have been denied. Conversely, if the U.S. parent had owned a U.K. holding company which in turn owned both resident subsidiaries, group relief would have been available even though the (ultimate) control rested with a U.S. parent. If an intermediate U.K. holding company had been interposed, the fact that the group was owned and controlled from the U.S. would not have prevented losses being transferable between the U.K. resident subsidiaries by way of group relief. Therefore, the tax authorities argued that group relief was denied on the ground that the resident subsidiaries in the case at hand did not have a common corporate shareholder resident in the U.K., not on the ground that ultimate ownership and control lay in the U.S.[979]

The Tribunal starts its analysis by observing that the approach under Art. 24(5) is two-fold. First, it must be ascertained whether the foreign-owned resident is treated less favourably than it would have been if the parent company had been a U.K. resident. Secondly, is that difference in treatment solely on the ground that its capital is owned or controlled by the U.S. parent company?

The Tribunal accepts that the first condition is clearly met: if the parent company had been a U.K. resident, the tax liability of the resident subsidiary that accepts the surrender of group relief from the other resident subsidiary would be reduced. As to the second question, the Tribunal points out that there can be circumstances in which there is more burdensome taxation without the foreign ownership being the ground of the different treatment. For instance, if the accepting subsidiary would have requested to be able to accept a surrender of losses from its U.S. parent, that request would also be denied. Conversely, if the parent company had been a U.K. resident, the group relief would have been available for the parent company's losses. But the ground for the difference in treatment in that case would **not** be foreign ownership. Group relief would also be denied if the U.S. resident surrendering company had been a subsidiary or a sister company of the resident accepting company (with a common U.K. parent company). In other words, even though there is foreign ownership in this example, the real ground for the denial of the relief is that the surrendering company is not a U.K. resident, regardless of whether that surrendering company is also the parent company of the accepting company.

In *Boake Allen*, the House of Lords held that the actual ground for differentiation was not the shareholder's residence, but its liability to ACT. In order to support this argument, the House

[978] Art. 24(5) of the 1975 treaty, which is identical to Art. 24(5) OECD MC.
[979] In support of this argument, the tax authorities refer to the similar reasoning developed by the House of Lords in *Boake Allen* (see supra).

of Lords considered the example where the recipient of the dividend was a U.K. resident individual. In that example, the group income election would not be available even though the shareholder was a resident. The only reason why the benefit is denied in such a situation was that the shareholder was not liable to ACT. The Tribunal adds a further example, namely that of a resident incorporated charity. In that case, the group income election would also be denied even though the recipient of the dividend is a U.K. resident. Accordingly, the sole reason why the benefit is denied is the recipient's non-liability to ACT. The purpose of those examples was to show that the real ground of the different treatment was the recipient's liability to ACT. Since the distinction was not based on the foreign ownership, there was no discrimination.

In the present case, the Tribunal considers that there is no other ground than foreign ownership on which the distinction is based. Unlike *Boake Allen*, there is no other reason such as liability to ACT that can explain why the benefit is not granted where the parent company is a non-resident. According to the Tribunal, the fact that there are other examples where the difference in treatment does **not** depend on the residence of the owner is irrelevant to whether there is discrimination in the case at hand. In particular, since Art. 24(5) prohibits discrimination on the ground of either **direct or indirect** foreign ownership, it is sufficient that there is discrimination on the ground of direct, though not indirect, ownership. Accordingly, the example given by the tax authorities as regards the possibility to interpose a U.K. holding company (see supra) merely demonstrate that there is no discrimination on the basis of **indirect** ownership. Similarly, the fact that the benefit is not available where the shareholder is a resident individual is irrelevant to whether there is discrimination on the ground of the parent company's residence; it merely shows that there is no discrimination on the basis that an individual shareholder is a non-resident.

The Tribunal therefore considers that the U.K. measure at issue constitutes discrimination contrary to Art. 24(5).

2. Analysis

The Tribunal takes a clear and thorough approach to the application of Art. 24(5) to the measure at issue and its conclusion is to be applauded. As pointed out above, national measures that take account of the relationship between companies belonging to a corporate group should not automatically be excluded from the scope of Art. 24(5). Instead, it should be ascertained in each case whether the conditions for the application of that provision are met.

It is noteworthy that the Tribunal expressly considers the relevant paragraphs of the Commentary in this respect. In particular, the Tribunal observes that *"paragraph 77 states (correctly) that the provision relates only to the taxation of the enterprise concerned and not of the persons owning its capital, but why does it follow 'that it cannot be interpreted to extend the benefits of rules that take account of the relationship between a resident enterprise and other resident enterprises (e.g. rules that allow consolidation, transfer of losses or tax-free transfer of property between companies under common ownership)'? Such items seem to us to relate solely to the enterprise under consideration and not to the taxation of the owner"*[980].

[980] First-Tier Tribunal (Tax) 24 March 2010, *FCE Bank Plc*, 2010 *UKFTT* 136, para. 30.

The Tribunal correctly points out that *"the focus of the discussion is that grouping of losses etc. might not be claimed where one group company is resident and the other non-resident"*. This is, for instance, the case, where a resident subsidiary requests consolidation with its non-resident parent[981]. But that was not the issue in the case at hand. *FCE Bank* concerned the grouping of profits and losses between domestic subsidiaries of a non-resident parent company in the same State. According to the Tribunal, that issue *"is not expressly addressed in the Commentary, which suggests that this was not a concern and might be why countries with court decisions to the effect that the treaty provision allows grouping in this situation did not object to the Commentary."*

III. The disadvantage-test: 'other or more burdensome'

III.A. General

a. The origin of the expression

Article 24(5) refers to *"other or more burdensome taxation and connected requirements"*. Thus, unlike Art. 24(3) (which refers to *"less favourable taxation"*), the wording used is exactly the same as in Art. 24(1). It is clear from the history of the provision, and particularly the reports of Working Party no. 4 of the OEEC Fiscal Committee, that this is not a coincidence.

When the Swiss delegation proposed to include a provision on foreign ownership, the Working Party immediately pointed out that the proposal would have little effect in practice. According to the Working Party, the situations for which the proposed paragraph was intended were often already covered by the nationality non-discrimination provision. Since nationality of legal persons was defined in terms of the governing law (*"deriving their status as such"*), there are two possibilities for a company incorporated in State A and controlled by residents of State B. First, if the company is considered to be governed by the law of State B because it is controlled by residents of State B[982], it will already be protected by the nationality non-discrimination clause: since nationality is defined in terms of governing law, the company is a State B national. Secondly, if the company is governed by State A law because it is incorporated in that State, it would be very unlikely for State A to discriminate against that company (i.e. it would be very unlikely for State A to treat two companies governed by its law differently on account of the residence of the shareholders), particularly when the nationality non-discrimination clause would prohibit State A to treat companies governed by its law better than companies governed by State B law[983].

The Working Party thus considered the importance of the proposed paragraph to be limited to cases where the foreign ownership of the company did not give rise to different nationality. In other words, when it was first introduced, the ownership non-discrimination clause was seen as complementing the nationality non-discrimination clause in those cases. For that reason, the OECD MC now treats discrimination in the same way when the distinction is based on the governing law (i.e. nationality) of a company as when it is based on the residence of its shareholders: both are concerned with "other or more burdensome taxation and connected

[981] See also supra, on the influence of the distributive treaty provisions on this discussion.
[982] That is to say, if State B uses the place of effective management, or a criterion of a similar nature, to determine which companies are governed by its law.
[983] FC/WP4(57) 2, 7-8.

requirements"[984]. As a result, the starting point of the analysis should be that this expression must be given the same interpretation in Art. 24(5) as in Art. 24(1).

b. Interpretation

That means, first of all, that the less favourable treatment should be assessed in isolation, without considering, for instance, whether the measure at issue generally favours foreign-owned companies.

> For instance, the Swedish Supreme Administrative Court decided an interesting case involving a Dutch parent company with two Swedish subsidiaries[985]. The parent company carried out a number of reorganizations in Sweden, the last of which was the merger of its Swedish subsidiaries. Under the Swedish rules at issue, the losses previously incurred by the subsidiaries could no longer be offset after the merger because the parent company was not Swedish. The Supreme Administrative Court was asked whether that infringed the ownership non-discrimination clause of the Dutch/Swedish treaty.
>
> The interesting aspect of this case is that, if the parent company had been Swedish, the losses in question would have been forfeited at an earlier stage of the reorganization (namely when one of the Swedish subsidiaries acquired the shares in another Swedish company that was not a member of the group). Due to an oversight of the Swedish legislator, that did not happen if the parent was a non-resident. Accordingly, if the reorganization was considered as a whole, there was no discrimination since the end result was exactly the same regardless of the parent company's residence. If all the transactions were considered together, neither the foreign-owned, nor the domestically-owned subsidiary would be able to carry over the losses: the foreign-owned subsidiary would lose the carry-over as a result of the merger, while the domestically-owned subsidiary would have already been deprived of the losses as a result of the earlier transaction.
>
> However, the Court refused to take account of the tax treatment of the earlier transaction, instead considering the merger in isolation. Since the Swedish rules precluded resident companies from carrying over losses after a merger on the basis that their parent company was non-resident, the Court decided that there was discrimination contrary to the ownership non-discrimination clause[986].

Additionally, the expression 'connected requirements' should be interpreted as referring to the requirements connected with the taxation of the subject of comparison[987]. As Art. 24(5) is

---

[984] See also J. AVERY JONES, "Understanding the OECD Model Tax Convention: the lesson of history", *Florida Tax Review* 2009, 41-45.
[985] *RÅ* 1997, ref 206, discussed in K. STÅHL, "The application of the treaty non-discrimination principle in Sweden", *Intertax* 2000, 197.
[986] As discussed in 2.B.VI.A, the Swedish Supreme Administrative Court took the exact same position with respect to Art. 24(1).
[987] For an example, see Amsterdam Court of Appeal 4 June 2003, No. 00/1652. That case concerned the Dutch tax regime of 'fiscal investment enterprises'. Under that regime, Dutch fiscal investment enterprises were granted a credit for foreign source tax withheld on dividends received. The credit was proportionally reduced depending on the number of non-resident shareholders. The taxpayer argued that that reduction fell foul of the ownership non-discrimination clause in the applicable tax treaties. The Court of Appeal decided in favour of the taxpayer and held that it was irrelevant that the domestic measure did not concern 'taxation' as such but a fiscal concession (i.e. a credit for foreign tax withheld at source). According to the Court, the expression 'other or more burdensome' did not only cover the tax rate, but also the additional requirements and benefits. In that respect, it was irrelevant whether the 'more burdensome' result for the subject of comparison was caused by a higher rate, a broader tax base or anything else (paras. 5.31.1 to 5.31.3 of the decision). The taxpayer also challenged the Dutch rules on the basis of the fundamental freedoms. The case ultimately ended up before the

only concerned with discrimination of the resident, foreign-owned enterprise (see supra), it should not be extended to rules concerning the taxation of other persons, such as the persons owning the capital of that enterprise. For that reason, rules imposing withholding tax obligations with respect to dividends paid to non-residents but not with respect to dividends paid to residents do not fall within the scope of Art. 24(5)[988], since those 'connected requirements' concern the taxation of the recipient of the dividends and not the taxation of the resident company paying the dividends.

The Commentary is very brief on what constitutes *"more burdensome taxation and connected requirements"* in the context of Art. 24(5). The only reference thereto is the statement that, *"in the case of transfer pricing enquiries, almost all member countries consider that additional information requirements which would be more stringent than the normal requirements, or even a reversal of the burden of proof, would not constitute discrimination within the meaning of the Article"*[989]. This is similar to the statement in the Commentary that Art. 24(4) *"does not prohibit additional information requirements with respect to payments made to non-residents since these requirements are intended to ensure similar levels of compliance and verification in the case of payments to residents and non-residents"*[990].

As discussed in the context of Art. 24(4), it is questionable to simply state that the application of increased information requirements (including a reversal of the burden of proof) does not constitute a disadvantage contrary to the non-discrimination clause. Nothing in the text of Art. 24(5) suggests that such requirements do not constitute 'less favourable taxation or connected requirements'.

A more appropriate argument would be that the different position as regards the availability of information renders non-residents incomparable to residents. Nevertheless, it could be argued that the lack of information as regards non-resident parent companies is inextricably linked with their non-residence. Since characteristics that are inextricably linked with the comparative attribute should be left out of the comparability-analysis, that factor cannot render resident subsidiaries of a non-resident parent incomparable to resident subsidiaries of a resident parent[991].

Dutch Supreme Court, which referred the question concerning the fundamental freedoms to the ECJ, without addressing the tax treaty issue (Hoge Raad 14 April 2006, No. 40037). The ECJ's decision in that case (C-194/06, *Orange European Smallcap Fund*) will be discussed in Part III, I.A.b.6.b.6.

[988] See also Comm. OECD on Art. 24, para. 78.

[989] Comm. OECD on Art. 24, para. 80. As an example, see U.S. Internal Revenue Code § 6038 A, which imposes increased reporting and record-keeping requirements on foreign-owned corporations. U.S. Congress feels that this is in accordance with Art. 24(5), since the measure only addresses certain administrative problems which arise with respect to the compliance and control of such corporations (K. VOGEL, *o.c.*, 1330, No. 162).

[990] Comm. OECD on Art. 24, para. 75. See also Comm. OECD on Art. 9, para. 4: *"almost all Member countries consider that additional information requirements which would be more stringent than the normal requirements, or even a reversal of the burden of proof, would not constitute discrimination within the meaning of Article 24"*.

[991] See also 2.E.IV.C.a and Part III, 2.F.III.

III.B. Case law

a. The Delaware case[992]

1. The decision of the BFH

The taxpayer was the German subsidiary of a company incorporated in the U.S. In the tax year at issue, the parent company transferred its management to Germany. In the same year, the taxpayer and the parent entered into an 'Organschaft', which meant that the companies agreed to form a fiscal unity. Under the German rules applicable at the relevant time, a company could only be regarded as a fiscal unity parent ('Organträger') if it was not tax exempt and had its statutory seat and its place of management in Germany. Additionally, a non-resident company could be regarded as Organträger if it had a PE in Germany and was subject to limited tax liability in Germany.

Because the statutory seat of the parent company in the present case was not in Germany, the German tax authorities refused to recognise the fiscal unity agreement, even though it was liable to unlimited taxation in Germany due to its place of management being located there. Moreover, because the parent had moved its place of management to Germany, it was a resident for the purposes of German domestic tax law and could therefore not be considered as a non-resident subject to limited tax liability in Germany. The taxpayer argued that this refusal fell foul of the ownership non-discrimination clause of the applicable tax treaty[993].

The BFH decided in favour of the taxpayer and held that the German rules constituted discrimination. The BFH found support for this conclusion in the ECJ's decision in *Überseering*[994]. The BFH acknowledged that that decision was only directly relevant and binding for Member States, with the result that legal persons of third States cannot derive any rights from it. However, the BFH states that *"the case is different with respect to U.S. corporations because of the bilateral anti-discrimination rule of Art. 24(4) U.S. DTC 1989. Tax disadvantages of domestic subsidiaries of U.S. corporations cannot be accepted compared to other similar domestic companies and as a consequence cannot be treated disadvantageously compared to companies within EC Member State"*[995].

In applying the ownership non-discrimination clause of the German/U.S. tax treaty, the BFH first addresses the treaty entitlement of the taxpayer. In that respect, it points out that protection from discrimination under that clause is accorded to enterprises of a contracting State, the capital of which is owned or controlled by residents of the other contracting State and that Art. 4(1) of the German/U.S. treaty defines a resident as *"any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature"*.

According to the BFH, that definition of residence applied to the parent in the present case, irrespective of whether it was actually liable to pay corporate income tax or not in the U.S. Since the parent company had its place of incorporation and statutory seat in the U.S. and its place of management in Germany, it was resident in both States. Art. 4(3) of the treaty provided that, if a person other than an individual was a resident of both Contracting States, the competent authorities of the Contracting States had to settle the question by mutual agreement and if they were unable to do so, *"such person shall not be considered to be a*

[992] BFH 29 January 2003, 6 *ITLR* 318.
[993] Art. 24(4) of the 1989 German/U.S. treaty, which is identical to Art. 24(5) OECD MC.
[994] ECJ 5 November 2002, C-208/00.
[995] BFH 29 January 2003, 6 *ITLR* 331 (as translated in *ITLR*).

resident of either Contracting State for purposes of enjoying benefits under this Convention"[996].

As there had been no attempts to reach a mutual agreement concerning the parent company's residence for tax treaty purposes, the German tax authorities assumed that it was not a resident of either State. The BFH, however, points out that *"even if that view was right, […] it would have neither an effect on the treaty protection of the appellant nor on the non-discrimination protection of Art. 24(4) U.S. DTC 1989"*[997]. According to the BFH, the 'non-resident fiction' of Art. 4(3) of the treaty was irrelevant to the present discussion because it only applied *"for the purposes of enjoying benefits under this Convention"*. Referring to German legal writing, the BFH held that it was commonly accepted that that 'fiction' only applied for the purposes of the taxation of dual residents, but not for other persons who are eligible for treaty benefits. The parent company in the present case was such an 'other person who is eligible for treaty benefits'.

Moreover, the parent company is expressly included within the scope of application of the ownership non-discrimination clause. The BFH acknowledges that the parent company referred to in that clause must be a 'resident' of the other contracting State – i.e. the U.S. in the present case – but it points out that the term 'resident' in that context only refers to *"the actual residence of the particular parent company within the meaning of Art. 4(1) U.S. DTC 1989 […] and not a fictitious residence within the meaning of Art. 4(3) U.S. DTC 1989"*. Moreover, the ownership non-discrimination rule does not protect the (dual resident) parent, but only the resident subsidiary. The BFH finds additional support for its position that only the 'actual' residence is relevant under Art. 24(5) in the fact that a dual resident company cannot be denied protection under Art. 24(1) of the treaty on the basis that it is not a resident of either contracting State. In that respect, the non-discrimination rule applies *"comprehensively and unlimitedly"*[998].

The Court finds further support for this conclusion in Art. 24(6) of the treaty, which, in line with the OECD MC, provides that the non-discrimination provision applies to taxes of every kind and description. Consequently, the provision does not only apply to the taxes mentioned in Art. 2 but also to those taxes – for instance VAT – which apply independently of a taxpayer's residence. Given that wide scope of application, the BFH holds that the non-discrimination provision cannot be denied for those taxes mentioned in Art. 2 which fall within the scope of the treaty, merely on the basis that the residence requirement is not fulfilled under Art. 4. Otherwise, the effect of the non-discrimination provision as regards

---

[996] Thus, the 1989 German/U.S. treaty did not follow the OECD MC, which uses the place of effective management as the tie breaker rule in Art. 4(3).

[997] BFH 29 January 2003, 6 *ITLR* 332 (as translated in *ITLR*).

[998] BFH 29 January 2003, 6 *ITLR* 324: *"Sie wird zusätzlich über Art 24 Abs 4 DBA-USA 1989 ausdrücklich in den Schutzbereich des Diskriminierungsverbotes einbezogen. Diese Einbeziehung erfolgt zwar gleichermaßen ausdrücklich unter Bezugnahme auf die Beteiligung oder Beherrschung durch eine in dem anderen Vertragsstaat - hier die USA – 'ansässige' Person. Das ändert aber nichts daran, dass damit nur die tatsächliche Ansässigkeit der jeweiligen Muttergesellschaft iS des Art 4 Abs 1 DBA-USA 1989, nicht aber die fingierte Ansässigkeit gemäß Art 4 Abs 3 2 Satzteil DBA-USA 1989 gemeint sein kann. Denn die betreffende Abkommensvergünstigung - den Diskriminierungsschutz - nimmt nicht die (doppelt ansässige) Muttergesellschaft, sondern die Tochtergesellschaft in Anspruch, was wiederum das Eingreifen der Ansässigkeitsfiktion ausschließt. Dass es für die Tochtergesellschaft (nur) auf die tatsächliche Ansässigkeit ankommt, verdeutlicht überdies der Umstand, dass selbst die doppelt ansässige Gesellschaft sich bei Inanspruchnahme des Diskriminierungsverbotes gemäß Art 24 Abs 1 Satz 2 DBA-USA 1989 die Nichtansässigkeit nicht entgegenhalten lassen müsste; das Verbot wirkt insoweit umfassend und uneingeschränkt"*.

these taxes would fall behind the protection offered in respect of taxes to which the scope of application of the provision has been extended under Art. 24(6).

The BFH therefore concludes that the German tax authorities must recognize the fiscal unity agreement, regardless of the residence requirement imposed on the Organträger under German domestic law. In an earlier decision, the BFH had reached a different conclusion[999]. However, that decision was based on the fact that, under German domestic law, a German company would also be excluded from Organträger status if it transferred either its statutory seat or its place of management abroad. A company incorporated in Germany which transferred its place of management or statutory seat abroad 'compulsorily' causes its own dissolution according to the 'seat theory', which prevailed in Germany at the time. Consequently, that company could no longer be regarded as an Organträger under German law.

However, that situation could not be compared to that of a company which transfers its place of management or its statutory seat **from abroad to Germany**. While the first case concerns the transfer of the place of management or statutory seat of a German company to a foreign country (i.e. the case of a German company migrating outward), the latter case concerns a foreign company migrating inward. With regard to the first case, the German legislator has the jurisdiction to sanction the outward migration with certain legal consequences. However, that was not at issue in the case at hand. The present case concerned a company migrating to Germany, in which case the German rules were discriminatory. The BFH therefore holds that a company that migrates to Germany should not be compared to a German company that migrates outward, but to a German company that remains resident in Germany with its place of management and statutory seat in Germany.

Finally, the Court repeats that in *Überseering*, the ECJ held that the freedom of establishment was infringed if a company that transferred its place of management inward was discriminated against. The BFH concludes that, in light of that violation of the EU Treaty, it cannot conclude differently with regard to the ownership non-discrimination rule of the German/U.S. treaty. Consequently, the U.S. company migrating inward should also be able to operate as an Organträger if it has its statutory seat in the U.S. Thus, Germany *"is not entitled to apply special tax rules based on the transfer of the place of management as it is also not entitled to do so within the European Community"*[1000].

2. Analysis

1. The dual residence issue

As a preliminary note, it should be pointed out that the outcome of the case would have been different if the parent company had not been a German resident for purposes of German

[999] BFH 13 November 1991, *BStBl* II 1992, 263.

[1000] BFH 29 January 2003, 6 *ITLR* 335 (as translated in *ITLR*). The original text of the decision reads as follows: *"Vor dem Hintergrund dieser Verletzung des EGV kann im Hinblick auf das in Art 24 Abs 4 DBA-USA 1989 enthaltene Diskriminierungsverbot nicht anders entschieden werden. Die Klägerin darf als inländische Beteiligungsgesellschaft eines US-amerikanischen Unternehmens keiner anderen oder belastenderen Besteuerung unterworfen werden als andere ähnliche inländische Unternehmen, auch nicht in Bezug auf dessen Ansässigkeit. [...] Für die Anerkennung des körperschaftsteuerrechtlichen Organschafts-verhältnisses bedeutet dies, dass die zuziehende amerikanische Gesellschaft auch dann als Organträger [...] fungieren kann, wenn sie über einen statutarischen Sitz in den USA verfügt. Der andere Vertragsteil - hier die Bundesrepublik - ist ebenso wie innerhalb der EG und des Geltungsbereichs des EGV nicht befugt, an den Wechsel des tatsächlichen Verwaltungssitzes besondere Besteuerungsfolgen zu knüpfen."*

domestic law (i.e. if its place of management had not been transferred to Germany). In that case, there would be no dual residence issue under the tax treaty, since the parent company could only be considered a U.S. resident.

Germany could then argue that, even if there was discrimination contrary to the ownership non-discrimination clause, that discrimination could not be said to violate the tax treaty because Germany is not entitled to tax the profits of the U.S. company. Since that company is not a German resident for the purpose of the tax treaty, its profits cannot be taken into account in Germany, with the result that the Organschaft regime cannot be applied[1001].

The same would be true if the parent company did move its place of management to Germany (i.e. if the facts were the same as they occurred in practice), but the tie-breaker rule of the tax treaty used the place of incorporation to resolve the issue of dual residence[1002]. If that were the case, the German resident company would be owned by a resident of the other contracting State (since, under the tie-breaker rule, the parent company would be a U.S. resident). Even though the German subsidiary would be treated less favourably than the German subsidiary of a German resident parent company, that difference in treatment could not be said to violate the provisions of the treaty since Germany would be unable to take the parent company's profits into account because of the parent company's non-residence. Therefore, insofar as the application of the Organschaft regime requires Germany to consider the profits of the parent company, the German subsidiary would be unable to invoke the ownership non-discrimination clause with respect to disadvantages resulting from the inapplicability of that regime.

2. The tie-breaker rule

An additional point to be addressed is that the applicable treaty deviated from the OECD MC, in that the residence tie-breaker rule for companies was not decided on the basis of the place of effective management. Instead, the treaty required the competent authorities to settle the question by mutual agreement, in the absence of which the taxpayer was considered a resident of neither State. If the treaty had followed the OECD MC, the parent company would have been a German resident for tax treaty purposes. In that case, the ownership non-discrimination clause would not have been applicable, since the taxpayer would then not be controlled by a resident of the other contracting State.

Could the **parent** then argue that it was discriminated against in Germany on the basis of nationality? The parent, a German resident U.S. national, was unable to qualify as an

---

[1001] This point is also made in the circular that was issued by the German Ministry of Finance in order to clarify the effect of the decision discussed here (Bundesministerium der Finanzen, "Diskriminierungsverbote der Doppelbesteuerungsabkommen; BFH-Urteil vom 29. Januar 2003", *BstBl* I 2004, 1181: *"Ein Organschaftsverhältnis setzt grundsätzlich zwingend die inländische Steuerpflicht sowohl des Organträgers als auch der Organgesellschaften voraus. [...] Eine inländische Gesellschaft, deren Kapital ganz oder teilweise unmittelbar oder mittelbar einer nur im anderen Vertragsstaat ansässigen Person gehört oder ihrer Kontrolle unterliegt, befindet sich im Hinblick auf die Besteuerung als Teil eines Organ- oder Konsolidierungskreises nicht in der gleichen Lage wie eine inländische Gesellschaft, deren Kapital einer inländischen Gesellschaft gehört oder ihrer Kontrolle unterliegt. Würde eine Organschaft mit einem ausländischen Organträger, der seine Geschäftsleitung im Ausland hat, anerkannt, wäre der Gewinn der Organgesellschaft der inländischen Besteuerung entzogen. Selbst wenn auf den Organträger zugegriffen werden könnte, wäre die inländische Besteuerung seiner Gewinne entsprechend Artikel 7 Abs. 1 Satz 1 OECD-Musterabkommen untersagt"*).

[1002] Admittedly, such a tie-breaker is rare in practice, but it is mentioned here because it is relevant in an example given in the Commentary on Art. 24 since the 2008 update. That example will be discussed hereafter.

Organträger. In contrast, a German resident company having German nationality would have qualified. Is that difference in treatment contrary to Art. 24(1)?

As pointed out in 2.B.III.B.b, the 2008 update has included an example in the Commentary that seems to have been inspired by the *Delaware* case. The facts of that example are identical to the case discussed here, except that the applicable treaty in the example has a residence tie-breaker rule based on the company's place of **incorporation**. In the example, the domestic tax law of State A provides that companies incorporated in that State or having their place of management there are residents. Under the domestic tax law of State B, companies incorporated in that State are residents. The domestic tax law of State A further provides that companies that have been incorporated **and** that have their place of management in State A qualify for a group consolidation regime. Company X is incorporated in State B but has its place of management in State A. It belongs to the same group as two companies that are incorporated in State A and have their place of management there. Because it was not incorporated in State A, company X is not entitled to consolidate its income with that of the other two companies.

The Commentary points out that State A's domestic group consolidation regime does not give rise to discrimination contrary to Art. 24(1). Since company X is not a State A resident under the treaty tie-breaker rule, it is not in the same circumstances as companies incorporated in State A that have their place of management there. So even though the different treatment results from the fact that company X is not incorporated in State A, that cannot be said to constitute discrimination on the basis of nationality because, in reality, it is discrimination on the basis of residence[1003].

The outcome of the case would arguably be different if the tie-breaker rule in the applicable tax treaty followed the OECD MC. Since the company's place of effective management would then be decisive as regards the residence issue, it would be a State A resident for tax treaty purposes. As a result, it cannot be said that it is incomparable to a company incorporated in State A that has its place of effective management there. Indeed, the sole difference between both companies is their nationality, i.e. their place of incorporation. In my opinion, the refusal to apply the consolidation regime in such a case would constitute nationality discrimination contrary to Art. 24(1).

3. The influence of European tax law

Before *Überseering*, German courts traditionally held that a company that moved its place of management to Germany was unable to be a party to legal proceedings unless it was reincorporated in Germany[1004]. As regards companies moving their seat from another EU Member State to Germany, that position had to be changed after *Überseering*.

[1003] That is to say, the situations are incomparable because of the relevant difference in residence. It is clear that residence is a relevant factor with respect to the consolidation regime since the distributive rules of the tax treaty prevent State A from taxing certain types of income derived by company X because of its State B residence (see Comm. OECD on Art. 24, para. 25).

[1004] Under German procedural law, an action brought by a party which did not have the capacity to bring legal proceedings was dismissed as inadmissible. Any person, including a company, having legal capacity had the capacity to be a party to legal proceedings (legal capacity being defined as the capacity to enjoy rights and to be the subject of obligations). It was settled case-law in Germany that a company's legal capacity was determined by reference to the law applicable in the place where its place of effective management was established (real seat principle), as opposed to the incorporation principle, by virtue of which legal capacity is determined in accordance with the law of the State in which the company was incorporated. That rule also applied where a

In the *Delaware* case, the BFH concludes that, because of the ECJ's decision in *Überseering*, Art. 24(5) OECD MC requires the German Organschaft to be extended to resident companies owned by residents of the other contracting State. That could mean one of two things. Either the BFH interprets Art. 24(5) OECD MC analogously to the fundamental freedoms (which would mean that the protection offered under the tax treaty non-discrimination clause is the same as the protection offered under the freedoms)[1005], or the BFH considers that the 'national treatment' which serves as the benchmark under Art. 24(5) includes advantages granted under the EU Treaty. Apparently, the BFH takes the latter approach, since it states that Art. 24(5) means that "*tax disadvantages of domestic subsidiaries of U.S. corporations cannot be accepted compared to other similar domestic companies and* ***as a consequence cannot be treated disadvantageously compared to companies within EC Member States***"[1006].

That line of reasoning is not entirely convincing. As pointed out earlier, tax advantages granted as a result of specific regional instruments seeking to achieve legal integration (e.g. the EU Treaty) go beyond the 'national treatment' to which the subject of comparison's treatment is compared under Art. 24[1007]. Such tax advantages are granted with the specific purpose of achieving market integration between the member States of the regional instrument in question. The entitlement to those benefits is inherently linked with the status as a resident of a State that is a party to that regional instrument. As a result, those benefits cannot be extended on the basis of a non-discrimination clause in a tax treaty[1008].

On the other hand, it is also possible that the BFH interprets the ownership non-discrimination clause **in line with** the ECJ's interpretation of the fundamental freedoms. That possibility will be further addressed in Part IV, 2.B.I.A.e.

b. Luxembourg Administrative Court of Appeal 19 April 2007[1009]

A Belgian parent company had six Luxembourg subsidiaries. One of the subsidiaries was loss-making, while the other five were profitable. The subsidiaries requested the application of the Luxembourg group treatment in order to set off the losses incurred by the loss-making subsidiary against the profits of the other subsidiaries.

---

company had been validly incorporated in another State and subsequently transferred its place of effective management to Germany. Since a company's legal capacity was determined by reference to German law, it could not enjoy rights or be the subject of obligations or be a party to legal proceedings unless it was reincorporated in Germany in such a way as to acquire legal capacity under German law. In *Überseering*, the ECJ held that that requirement fell foul of the fundamental freedoms.

[1005] Possibly because the interpretation given by the ECJ to the fundamental freedoms influences the BFH's interpretation of the tax treaty non-discrimination provision. On that possibility, see infra.

[1006] BFH 29 January 2003, 6 *ITLR* 331 (as translated in *ITLR*) (emphasis added). The original German text is: "*Besteuerungsnachteile inländischer Tochterunternehmen von US-amerikanischen Unternehmen gegenüber anderen ähnlichen inländischen Unternehmen sind hiernach nicht hinzunehmen und* ***können deswegen im Ergebnis keiner für sie ungünstigeren Beurteilung als Unternehmen innerhalb der EG unterfallen***" (BFH 29 January 2003, 6 *ITLR* 322; emphasis added).

[1007] That is to say, those benefits do not form part of the treatment to which the object of comparison is entitled when it is ascertained under Art. 24 OECD MC whether that object of comparison is treated less burdensome/more favourably/differently than the subject of comparison.

[1008] On the opposite scenario, i.e. the question whether the EU Treaty freedoms require an EU Member State to extend the benefits granted under a tax treaty to residents of other EU Member States, see Part III, I.A.b.9.

[1009] Cour Administrative 19 April 2007, No. 21979 C.

Under Luxembourg tax law, a group treatment regime could be applied to resident subsidiaries with a resident parent company (or where the shares in the subsidiary were held by the Luxembourg PE of a foreign company). That regime meant that the profits and losses of the subsidiaries were integrated for tax purposes with those of the parent company[1010]. Since the parent company in the present case was not resident in Luxembourg, the Luxembourg tax authorities refused the application of the group treatment rules. The Luxembourg subsidiaries argued that this refusal constituted discrimination contrary to the ownership non-discrimination clause of the Belgian/Luxembourg treaty[1011].

The Court first noted that the taxpayers' claim concerned the 'horizontal' compensation of profits and losses between the different Luxembourg subsidiaries, while the Luxembourg group treatment regime only allowed the 'vertical' compensation of profits and losses between a parent company and its subsidiary. Since Luxembourg subsidiaries of a Luxembourg parent companies were not entitled to horizontal compensation either, there was no discrimination contrary to the ownership non-discrimination clause.

In other words, neither the subject of comparison, i.e. the Luxembourg subsidiary of a Belgian parent company, nor the object of comparison, i.e. the Luxembourg subsidiary of a Luxembourg parent company, were able to consolidate their results with those of their Luxembourg 'sister' companies. As a result, there was no discrimination.

This case illustrates that it is essential to ascertain whether the object of comparison is entitled to the specific benefit at issue. If not, there is no discrimination. In the present case, the Court thus held that there was no discrimination because domestically-owned residents were not entitled to horizontal consolidation either.

However, the decision is questionable. While it is true that horizontal compensation as such was impossible under the Luxembourg rules at issue, those rules provided for a system of 'total' fiscal integration, i.e. vertical (between parent and subsidiaries) **and** horizontal (between the subsidiaries). Accordingly, if the parent company had been a Luxembourg resident, there would have been horizontal compensation, **in addition to** vertical compensation[1012]. Clearly, the vertical aspect of the Luxembourg regime of total integration could not be applied in the present case because Luxembourg was not entitled to tax the parent company's result under the tax treaty. For that reason, the claimants only requested application of the horizontal aspect of that regime, thereby ignoring the results of the non-resident parent.

So the Court's statement that the object of comparison would not be entitled to horizontal integration is not very convincing: such horizontal integration formed part of the total integration to which it was entitled. The fact that the claimants were unable to have the vertical aspect of the system applied to them should not affect their entitlement under Art.

[1010] The relevant provision (Art. 164bis LIR) read as follows: "*(1) les sociétés de capitaux résidentes pleinement imposables, dont 95% au moins du capital est détenu directement ou indirectement par une autre société de capitaux résidente pleinement imposable ou par un établissement stable indigène d'une société de capitaux non résidente pleinement imposable à un impôt correspondant à l'impôt sur le revenu des collectivités, peuvent, sur demande, être intégrées fiscalement dans la société mère ou dans l'établissement stable indigène, de façon à faire masse de leurs résultats fiscaux respectifs avec celui de la société mère ou de l'établissement stable indigène.* "

[1011] Art. 24(6) of the 1970 treaty, which is identical to Art. 24(5) OECD MC.

[1012] J. WINANDY and D. RICHTER, "National Report. Luxembourg", in *Non-discrimination at the crossroads of international taxation*, Amersfoort, Sdu Fiscale & Financiële Uitgevers, 2008, 379.

24(5) to those aspects of the system that can be applied. If I understand the Luxembourg rules correctly, there was nothing to prevent the Luxembourg tax authorities from granting the horizontal integration in the case at hand.

c. The Swedish Supreme Administrative Court on the interpretation of 'other'

A remarkably broad interpretation of 'other taxation' was given by the Swedish Supreme Administrative Court in 1993[1013]. The case concerned the Swedish regime on intra-group transfers, which was discussed earlier in 2.F.I.C. In the case at hand, a Swedish parent company had a U.S. subsidiary, which, in turn, had a Swedish subsidiary. The Swedish parent company wanted to give a group contribution to its Swedish sub-subsidiary. Since, in the case at hand, there was a non-Swedish intermediary company (i.e. the U.S. subsidiary), the Swedish parent was unable to deduct the contribution. The question arose whether that refusal constituted discrimination.

The income tax treaty applicable to the facts of the case[1014] did not contain an ownership non-discrimination clause. However, the 1983 inheritance and gift tax treaty between Sweden and the U.S. contained a clause identical to Art. 24(5) OECD MC[1015]. Moreover, that clause applied to taxes of every kind and description[1016]. For that reason, the Court considered the clause to apply to the case at hand.

However, the disadvantage (i.e. the non-deductibility of the transfer) was incurred by the Swedish parent company, which was not "owned or controlled by a resident of the other contracting State". The discrimination at issue was not on the basis of foreign ownership, but on the basis of the fact that the transferee was owned by a resident of the other contracting State. Yet, the transferee had not incurred any less favourable taxation as a result of the deduction being denied.

Nevertheless, the Court referred to the wording of the ownership non-discrimination provision and stressed that it prohibited not only 'less favourable' taxation but also 'other' taxation and connected requirements. The Court also noted that the OECD Commentary provided that the purpose of the ownership non-discrimination provision was to ensure equal treatment for taxpayers residing in the same State. From that, the Court concluded that, in this context, equal treatment had to be understood as requiring the transfer to be treated as an intra-group transfer at the level of the transferee and, as a consequence thereof, at the level of the transferring company as well. Otherwise, the transferee (i.e. the foreign-owned company) would not have the same opportunity as a domestically-owned company to achieve tax equalization within the group and that would constitute discrimination.

That approach is questionable. As pointed out above, the scope of application of Art. 24(5) is strictly limited to the foreign-owned company. Yet, the Swedish court takes the tax consequences for the whole group into account in order to determine whether there is discrimination. Clearly, that goes beyond the scope of Art. 24(5) (see supra). Moreover, as

---

[1013] *RÅ* 1993 ref 91 I, discussed in K. STÅHL, "The application of the treaty non-discrimination principle in Sweden", *Intertax* 2000, 198 and in M. NELSON, "Tax treaty interpretation in Sweden", in M. LANG (ed.), *Tax treaty interpretation*, Kluwer Law International, The Hague, 2001, 348-349.
[1014] I.e. the 1939 Sweden / U.S. treaty.
[1015] Art. 10(3) of the Convention between the U.S. and Sweden for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on estates, inheritances and gifts of 13 June 1983.
[1016] Art. 10(4) of the 1983 inheritance and gift tax treaty, which is identical to Art. 24(6) OECD MC.

pointed out above, the expression 'taxation and connected requirements' only refers to the taxation of the subject of comparison. Given the strict scope of application of Art. 24(5), that expression should not be extended to cover rules relating to the taxation of other persons.

If I understand the Swedish regime correctly, the transferee of the contribution (i.e. the Swedish sub-subsidiary) did not incur a disadvantage in the tax year at issue because of the inapplicability of the intra-group transfer regime. If that regime does not apply, the contribution is not deductible for the transferor and it is not taxed to the transferee. Assuming that the transferee has a loss (against which the contribution is intended to be set off), the application of the regime means that the transferee receives taxable income with the result that the loss is reduced. Since the transferee then loses the tax benefit of that loss, it will be subject to higher taxation in subsequent tax years than if it had not received the contribution (assuming that the loss can be carried forward). From that perspective, the inapplicability of the group regime did not give rise to any disadvantage for the transferee.

On the other hand, it could be argued that there is an advantage in being able to use the loss immediately instead of carrying it forward and possibly not being able to use it at all if there is a time limit on the loss carry-forward or if there are no future profits. From that perspective, the transferee does incur a disadvantage if the group regime does not apply. Indeed, if it does not apply, there is a risk that current losses will not give rise to any tax benefit in the future.

To some extent, the issue is thus influenced by the domestic regime on loss carry-forward. That is to say, if there is a time limit on the possibility to carry forward losses, it might be easier to argue that there is a disadvantage in not being able to take the loss into account immediately (i.e. by applying the intra-group transfer regime).

IV. Relationship to Article 24(4)

IV.A. General

Given the scope of application of both provisions, there may be an overlap between Article 24(4) and Article 24(5). If a resident company that is owned by a resident of the other contracting State is discriminated against with respect to the deductibility of payments made to its parent company as compared to a resident company with a resident parent company, both provisions could be applied simultaneously. This is of particular relevance to domestic thin cap rules, which often seek to curb erosion of the national tax base by denying the deductibility of the interest on excessive debt. In this respect, the Commentary traditionally took the position that Article 24(4) is the *lex specialis* in relation to Art. 24(5), with the result that Article 24(5) cannot be applied in such a situation: *"paragraph 5, though relevant in principle to thin capitalisation, is worded in such general terms that it must take second place to more specific provisions in the Convention. Thus paragraph 4 (referring to [Article 9(1)] and [Article 11(6)]) takes precedence over this paragraph in relation to the deduction of interest"*[1017].

[1017] Comm. OECD on Art. 24, para. 58 (in 2008, the paragraph in question was renumbered as para. 79). The same position was taken in OECD, "Thin Capitalisation. Report of the Committee on Fiscal Affairs", 26 November 1986, para. 66, where it is pointed out that, because Art. 24(5) is in such general terms, *"it must take second place to more specific provisions in the treaty. Thus Article 24(4) (referring to Article 9(1) and 11(6)) takes precedence over it in relation to the deduction of interest."*

In 2008, that statement has been replaced by a more elaborate discussion of this issue. The Commentary now provides that, because Art. 24(5) prohibits discrimination that is solely based on who owns or controls the capital of a resident enterprise, *"it would not prima facie be relevant with respect to rules that provide for a different treatment of an enterprise based on whether it pays interest to resident or non-resident creditors. The paragraph is not concerned with rules based on a debtor-creditor relationship as long as the different treatment resulting from the rules is not based on whether or not non-residents own or control, wholly or partly, directly or indirectly, the capital of the enterprise."*

As an example, the Commentary refers to a domestic thin cap rule under which a resident enterprise is not allowed to deduct interest paid to a non-resident associated enterprise. Such a rule does not violate Art. 24(5) even where it would be applied to interest payments made to a creditor that owns or controls the capital of the enterprise, provided that the treatment would be the same if the interest had been paid to a non-resident associated enterprise that did not own or control the capital of the payer. On the other hand, such a rule could be contrary to Art. 24(4) to the extent that different conditions apply for the deduction of interest paid to residents and non-residents. In that context, it must be determined whether the domestic rule at issue is compatible with Arts. 9(1) and 11(6).

The Commentary further observes that this would also be important for purposes of Art. 24(5) in the case of domestic thin cap rules that apply only to resident enterprises the capital of which is owned or controlled by non-residents: *"Indeed, since the provisions of [Art. 9(1)] or [Art. 11(6)] form part of the context in which paragraph 5 must be read (as required by Article 31 of the Vienna Convention on the Law of Treaties), adjustments which are compatible with these provisions could not be considered to violate the provisions of paragraph 5"*[1018].

In other words, the Commentary has changed its original position that Art. 24(4) always takes precedence over Art. 24(5) in the context of thin cap rules. Instead, it now provides that such rules should be tested against Art. 24(5) (and, presumably, not against Art. 24(4)) if they apply only to resident enterprises the capital of which is owned or controlled by non-residents. The Commentary states that, in such a situation, the carve-out made in Art. 24(4) with respect to Arts. 9(1) and 11(6) also applies to Art. 24(5), since those provisions form part of the context in which Art. 24(5) must be read. While this interpretation is certainly correct, it of course raises the question why the carve-out is expressly mentioned in the text of Art. 24(4) but not in Art. 24(5). Conversely, if the carve-out is already implicit in Art. 24(5) on the basis

[1018] Comm. OECD on Art. 24, para. 79. On this change, see OECD, "Application and interpretation of Article 24 (non-discrimination). Public discussion draft", 3 May 2007, paras. 82-83, where it is noted that *"the Commentary should be amended since paragraph 5 would generally not be relevant for most thin capitalisation rules because the direct focus of thin capitalisation rules is not the relationship between an enterprise and the persons who owns its capital (i.e. company-shareholder relationship) but, instead, the payment of interest from a resident enterprise to a non-resident related creditor (debtor-creditor relationship), which would seem to be outside the scope of paragraph 5 since that paragraph addresses discrimination based on foreign ownership of the capital of the enterprise. This was illustrated by the fact that the thin capitalisation rules of most countries would apply to a local company with a local parent that makes interest payments to foreign related companies. Under that view, thin capitalisation rules would generally be outside the scope of paragraph 5 as they would not constitute discrimination based on foreign ownership of the capital of a domestic enterprise but, instead, on the fact that the domestic enterprise has foreign related creditors. The Group also agreed that the Commentary should clarify that even if in cases where thin capitalisation rules apply only to enterprises of a Contracting State the capital of which is wholly or partly owned or controlled, directly or indirectly, by non-residents, these rules do not violate paragraph 5 to the extent that they result in adjustments to profits that are made in accordance with paragraph 1 of Article 9 or paragraph 6 of Article 11"*.

of Art. 31 VC, that should also be the case with respect to Art. 24(4) so there is no reason to mention it in the latter provision[1019].

That being said, the current approach of the Commentary is preferable to the original statement that Art. 24(4) always takes preference over Art. 24(5). Indeed, when the domestic thin cap rule applies solely to payments made to non-residents owning or controlling the resident company's capital, Art. 24(5) is arguably more specific than Art. 24(4)[1020]. In those situations Art. 24(5) should therefore be given preference. On the other hand, if the domestic rule applies to all interest payments made to associated non-residents, it seems that Art. 24(4) is the *lex specialis*.

So the underlying idea is that both provisions can, in theory, be applied, but preference is given to one because it is 'more specific', that is to say, because it relates more specifically to the characteristic of the domestic rule at issue. Art. 24(4) OECD MC concerns the taxation of interest (or other payments), while Art. 24(5) OECD MC relates to discrimination on the basis of foreign ownership. Where a domestic thin cap rule applies generally to all payments made to associated non-residents, it cannot be said that Art. 24(5) relates more specifically to the domestic rule at issue. Even if that rule is applied to a payment made to a non-resident parent company, Art. 24(5) is not the *lex specialis*[1021]. On the other hand, where the domestic rule applies exclusively to interest payments made to a non-resident parent company, it could be argued that Art. 24(5) is the *lex specialis* because the domestic rule discriminates directly on the basis of foreign ownership.

IV.B. Case law

a. Andritz

1. The decision of the Administrative Court of Appeal[1022]

The French subsidiary of an Austrian parent company deducted the entire amount of interest incurred on a loan from its parent. Under the French thin cap rules in force at the time, the deduction of interest was denied on sums exceeding 1.5 times the capital of the subsidiary if the loan was granted by a shareholder who controlled the company (in law or in fact) or who held more than 50% of the shares in the company.

The thin cap rule would not have applied if the Austrian company had been a 'parent company' as defined under French tax law[1023]. That definition required the company in

[1019] See also Bundesfinanzhof 8 September 2010, I R 6/09 (which is discussed in detail in Part IV, 2.B.I.A.b). In that case, the Bundesfinanzhof expressly held that the ownership non-discrimination clause of the German/Swiss treaty (which is identical to Art. 24(5) OECD MC) is not limited by Arts. 9(1) and 11(6). However, because that treaty was concluded in 1971, it did not include a deductibility non-discrimination provision analogous to Art. 24(4) OECD MC (which was only included in the MC in 1977). Consequently, the non-discrimination provision in the German/Swiss treaty did not refer to Arts. 9(1) and 11(6), with the result that it is difficult to draw any conclusion from this judgment with respect to the relationship between Arts. 24(4) and 24(5) OECD MC.

[1020] Similarly, J. AVERY JONES, "The non-discrimination article in tax treaties: part 2", *B.T.R.* 1991, 446.

[1021] An additional point is that Art. 24(5) might fail in such situations. That is to say, the subject of comparison under Art. 24(5) would be a resident company making a payment to its non-resident parent, while the object of comparison is a domestically-owned resident company making a payment to a related non-resident company. The fact that the payment was made specifically to the parent company is not a relevant characteristic, with the result that it should be left out of the comparison. As the object of comparison is not entitled to the deduction either, there is no discrimination.

[1022] Cour Administrative d'Appel de Nantes 13 March 2001, No. 97-2237, 4 *ITLR* 1.

question to be subject to French corporation tax at the normal rate, which would be the case if it was established in France or maintained a PE there which held the shares in the subsidiary[1024].

The subsidiary argued that the French thin cap rules fell foul of the ownership non-discrimination clause of the Austrian/French treaty[1025]. It is important to note that that treaty did not include a deduction non-discrimination clause (see infra). Moreover, the ownership clause of the treaty deviated from (the French version of) the OECD MC in that it did not refer to *"les autres entreprises similaires du premier État"* but to *"les autres enterprises de même nature de ce premier Etat"*[1026].

The Administrative Court of Appeal of Nantes decided in favour of the tax authorities. The Court held that the Austrian company could not be regarded as having the status of 'parent company' within the meaning of French tax law because it did not have a PE in France and was consequently not subject to French corporation tax at the normal rate. For that reason, the Austrian company was not *"of the same nature"* (*"de même nature"*; see supra) as companies which have this status as 'parent company', irrespective of where their seat is located[1027]. According to the Court, the ownership non-discrimination clause could only be applied if the Austrian company had been subject to French corporation tax at the normal rate.

The Commissaire du Gouvernement had reached the same conclusion in his Opinion, but his analysis was more elaborate, and rested on two separate arguments. First, he pointed out that the expression *"les autres enterprises de même nature"* should be understood as referring to resident companies owned by residents of a foreign country other than Austria, and not resident subsidiaries of French companies. According to the Commissaire, resident subsidiaries of French companies were not *"of the same nature"* as resident subsidiaries of Austrian companies[1028]. Since the taxpayer in the present case was not treated less favourably

---

[1023] See Article 212 CGI: *"Les intérêts afférents aux sommes que les associés laissent ou mettent à la disposition de la société sont admis dans les charges déductibles dans les conditions prévues à l'article 39-1-3°. […] La déduction n'est admise, en ce qui concerne les associés ou actionnaires possédant, en droit ou en fait, la direction de l'entreprise ou détenant plus de 50 p. 100 des droits financiers ou des droits de vote attachés aux titres émis par la société, que dans la mesure où ces sommes n'excèdent pas, pour l'ensemble desdits associés ou actionnaires, une fois et demie le montant du capital social.*
Cette limite n'est pas applicable : […] b. Aux intérêts afférents aux avances consenties par une société ou à une autre société lorsque la première possède, au regard de la seconde, la qualité de société mère au sens de l'article 145".

[1024] See Art. 145(1) CGI: *"Le régime fiscal des sociétés mères, tel qu'il est défini aux articles 146 et 216, est applicable aux sociétés et autres organismes soumis à l'impôt sur les sociétés au taux normal qui détiennent des participations satisfaisant aux conditions ci-après […]"*.

[1025] Art. 26(3) of the 1959 treaty.

[1026] The French version of the 1963 OECD Draft Convention also used the expression *"les autres enterprises de même nature"*. In the 1977 OECD MC, that expression was changed to *"les autres entreprises similaires"*. Remarkably, the text proposed by OEEC Working Party No. 4 used yet another expression: originally, the expression *"d'autres entreprises semblables établies dans le territoire de la première Partie Contractante et se trouvant dans la même situation"* was used, but that was later changed to *"les entreprises semblables établies dans le territoire de cette première Partie contractante et se trouvant dans la même situation"* (see 1.C).

[1027] Cour Administrative d'Appel de Nantes 13 March 2001, No. 97-2237, 4 *ITLR* 5: *"il est constant que la société Maschinen Fabrik Andritz AG, qui ne dispose en France d'aucun établissement stable et n'est par suite pas assujettie à l'impôt sur les sociétés au taux normal, ne peut de ce fait […] être regardée comme ayant la qualité de société mère telle que le prévoit l'article 145 du CGI et n'est donc pas, au sens de la convention précitée, de même nature que le sociétés qui, quel que soit le lieu de leur siège social, ont cette qualité de société mère."*

[1028] Conclusions du Commissaire du Gouvernement E. Grangé, 4 *ITLR* 9: *"il faut entendre par 'entreprises de même nature' […] celles qui sont détenues par des résidents d'un Etat étranger autre que celui partie à la* than French subsidiaries of a company in another State (other than Austria and France), there was no discrimination.

Secondly, if the Court would not accept that the proper comparison was with the resident subsidiary of a third State resident, the Commissaire pointed out that the parent company of the taxpayer in the present case could not be regarded as a 'parent company' within the meaning of French domestic law. Since the Austrian company did not have a PE in France, it was not subject to corporation tax at the normal rate and could, therefore, not be considered as a 'parent company' within the meaning of French domestic law. As a result, it could not be said that there was discrimination against the taxpayer as compared to the resident subsidiary of a company that qualified as a 'parent company' under the provisions of French domestic law since they were not in the same situation[1029].

2. The decision of the Conseil d'Etat

The taxpayer objected to the Conseil d'Etat, which reversed the Administrative Court of Appeal's decision. The Conseil d'Etat pointed out that that the French subsidiary of an Austrian parent company can be regarded as having *"the same nature"* as the French subsidiary of a French parent company, **not only** in the case where the Austrian parent company has a PE in France that would be subject in France to corporation tax at the normal rate, **but also**, in the absence of a PE, in the case where the parent company would have been subject in France to corporation tax at the normal rate if it exercised its activities in France. Therefore, the Administrative Court of Appeal was incorrect in deciding that the taxpayer in the case at hand did not have *"the same nature"* as the French subsidiary of a company qualifying as a 'parent company' within the meaning of domestic law **for the sole reason** that the taxpayer was owned by an Austrian company which, in the absence of a PE in France, was not subject to French corporation tax at the normal rate, without verifying whether the taxpayer would have *"the same nature"* as such a company if the Austrian company exercised its activities in France. Because the Administrative Court of Appeal made an error of law in interpreting the non-discrimination clause, its decision was annulled[1030].

---

convention, en l'espèce l'Etat autrichien, et non pas toutes les entreprises filiales c'est à dire notamment celles qui sont filiales de sociétés françaises. Celles-ci ne sont pas à notre avis […] de même nature que les sociétés visées par la clause, c'est à dire celles qui sont détenues par des résidents autrichiens."

[1029] Interestingly, the Commissaire does not say that the taxpayer is not *"of the same nature"* as the resident subsidiary of a qualifying 'parent company'. In his first argument, the Commissiare compared the taxpayer to the resident subsidiary of a third State resident and held that they were not *"of the same nature"*, within the meaning of the non-discrimination clause. His second argument seems to start from the assumption that the taxpayer should be compared to the resident subsidiary of a resident parent company (or, at the very least, the resident subsidiary of a company that qualifies as a 'parent company' under domestic law). Here, however, he does not conclude that they are not *"of the same nature"*, but that they are *"not in the same situation"*. See Conclusions du Commissaire du Gouvernement Grangé, 4 *ITLR* 10: *"Dans ces conditions, elle n'est pas fondée, en tout état de cause, à soutenir qu'elle serait traitée de manière discriminatoire par rapport à une société don't la société mère bénéfice du régime de l'article 145,* ***puisqu'elle ne se trouve pas dans la même situation****"* (emphasis added). It is not clear why the wording used in the second argument is different from the first.

[1030] Conseil d'Etat 30 December 2003, No. 233894, 6 *ITLR* 609: *"il résulte de l'article 26 § 3 de la convention franco-autrichienne que la filiale française d'une société mère autrichienne doit […] être regardée comme étant de 'même nature', au sens de cette stipulation, que la filiale française d'une société mère française, non seulement dans le cas où la société mère autrichienne disposerait en France d'un établissement stable qui détiendrait ou contrôlerait lui-même tout ou partie du capital de la filiale et serait imposé en France à l'impôt sur les sociétés au taux normal, mais encore, en l'absence d'un tel établissement, dans le cas où ladite société mère aurait elle-même été passible en France de cet impôt au même taux, si elle avait exercé son activité sur ce territoire; que, par suite, en jugeant que la SA Andritz ne revêtait pas, au sens de l'article 26 §3 précité de la convention […], la 'même nature' que la filiale française d'une société détenant la qualité de société-mère au*

The Conseil d'Etat therefore went on to decide the case on the merits[1031]. The Conseil d'Etat held that, having regard to its form and the nature of its activities, the Austrian company would have been subject to corporation tax at the normal rate in the tax years at issue if it had exercised its activity in France. Therefore, it would have qualified as the 'parent company' of the taxpayer under French domestic law in such a situation. For that reason, the Conseil d'Etat held that the taxpayer should be regarded as having *"the same nature"* for the purposes of the treaty non-discrimination clause as the French subsidiary of a company qualifying as a 'parent company' under French domestic law. The Conseil d'Etat therefore concluded that the non-discrimination clause prohibited France from subjecting the taxpayer to taxation that was other or more burdensome than the taxation of a French subsidiary that paid interest to a company qualifying as its 'parent company' under French domestic law[1032]. As a result, the thin cap rules could not be applied[1033].

3. Analysis

1. Relationship to Art. 24(4)

As pointed out above, the applicable tax treaty did not contain a clause analogous to Art. 24(4), which meant that the Conseil d'Etat was not required to address the relationship between Art. 24(4) and 24(5)[1034]. However, it is submitted that the conclusion should have been the same even if the applicable treaty had included such a deduction non-discrimination clause. The French thin cap rules at issue only applied if the loan was granted by a

---

sens de l'article 145 du code général des impôts, au seul motif que la société requérante était détenue par une société autrichienne qui, faute d'établissement stable en France, n'était pas assujettie dans cet Etat à l'impôt sur les sociétés au taux normal, et sans rechercher si cette dernière société aurait rempli les conditions prévues à l'article 145 susmentionné, dans l'hypothèse où elle eût exercé son activité en France, la cour a donné de ces stipulations une interprétation inexacte et entaché son arrêt d'une erreur de droit".

[1031] Pursuant to Article L821-2 Code de Justice Administrative, the Conseil d'Etat, when deciding to annull the decision of an administrative court, could either remit the case to the same court or a court of the same level, or decide the case on the merits itself if that was justified by the need to ensure the proper administration of justice.

[1032] Conseil d'Etat 30 December 2003, No. 233894, 6 *ITLR* 609-610: *"si elle avait exercé son activité en France, [Andritz] aurait, compte tenu de sa forme et de la nature de cette activité, été soumise à l'impôt sur les sociétés au taux normal au titre de chacun des exercices vérifiés; qu'elle aurait ainsi revêtu, en application de l'article 145 du code général des impôts et au regard de sa filiale française […] la qualité de société mère; que, par suite, cette filiale doit être regardée, au titre de chacun des exercices en cause, comme étant de même nature, au sens de l'article 26 § 3 précité de la convention […], que la filiale française d'une société détenant la qualité de société mère au sens de l'article 145 du code général des impôts; que, par voie de conséquence, ces stipulations conventionnelles font obstacle à ce [qu'elle] soit assujettie […] à une imposition qui soit autre ou plus lourde que celle prévue […] dans l'hypothèse où une société française verse à sa société-mère des intérêts, en rémunération des sommes laissées ou mises à sa disposition par l'intéressée"*. The Commissaire du Gouvernement took a similar approach. See Conclusions du Commissaire du Gouvernement Bachelier, 6 *ITLR* 631: *"Pour apprécier si sont de même nature au sens de l'article 26(3) une filiale française d'une société mère française et une filiale française d'une société mère autrichienne, il convient de rechercher si, même en l'absence d'un établissement stable, la société mère autrichienne aurait été passible de l'impôt sur les sociétés au taux normal si elle avait été française et avait exercé son activité en France. La circonstance qu'elle n'est pas imposée en France ne suffit donc pas à faire échec à la condition d'identité de nature des deux filiales selon que leur capital est détenu par une société française ou une société autrichienne."*

[1033] As a response to the alleged incompatibility of the French thin cap rules with tax treaty non-discrimination provisions, France has included a clause in its recent tax treaties, expressly authorising the application of these domestic rules (see B. BOHNERT, "National Report. France", in *Non-discrimination at the crossroads of international taxation*, Amersfoort, Sdu Fiscale & Financiële Uitgevers, 2008, 283) and has made to a reservation on Art. 24(4) to this effect in the OECD Commentaries (Comm. OECD on Art. 24, para. 91).

[1034] The applicable treaty was concluded in 1959, while Art. 24(4) was added to Art. 24 OECD MC in the 1977 Model (but it was numbered as 24(5) at the time; see 1.D).

shareholder who controlled the company (in law or in fact) or who held more than 50% of the shares in the company.

As discussed in 2.F.IV.A, Art. 24(5) is more specific than Art. 24(4) as regards a thin cap rule that applies exclusively to payments made to a non-resident owning or controlling the capital of the resident payor. So even if the applicable treaty had contained a provision analogous to Art. 24(4), it can be argued that the ownership non-discrimination clause had to be applied because it is the *lex specialis*. But that does not mean that the carve-out for Art. 9(1) and 11(6), provided for in Art. 24(4), is inapplicable (see infra). As pointed out earlier, that carve-out is implicit in Art. 24(5) as well, in that it forms part of the context in which the ownership provision should be interpreted.

2. The appropriate object of comparison

The decisive issue was the comparability-test. According the Administrative Court of Appeal, the ownership non-discrimination clause required that **the Austrian parent company** was *"of the same nature"* as a company qualifying under French law as a 'parent company'. Clearly, that is not the proper comparison[1035]. Instead, the non-discrimination clause requires **the resident subsidiary** of the Austrian parent company to be *"of the same nature"* as the resident subsidiary of a French parent company. Of course, it is possible that a difference at the level of the parent companies affects the comparability at the level of the subsidiaries, but that does not change the fact that the comparison should be made at the level of the resident subsidiary.

There is an additional question in this context that is not as straightforward as it may seem, namely whether the distinction was based solely on foreign ownership. As pointed out in 2.F.I.C.b, the Commentary states since 2008 that Art. 24(5) only applies if the domestic rule distinguishes 'solely' on the basis of foreign ownership[1036]. Here, however, the distinction was based on the parent company's liability to French corporation tax at the normal rate. That is to say, the interest was not deductible if:

1. the parent company was a non-resident
2. that did not have a PE in France nor carried out any taxable activities there.

> It is interesting to note in this regard that the relevant provisions of French tax law originally provided that only French limited liability companies could qualify as 'parent companies'[1037]. However, the Conseil d'Etat decided in 1985 that the PE non-discrimination clause of the French/Italian tax treaty required that residents of the other contracting State with a PE in France should also be able to qualify as 'parent companies' if the shares in the subsidiary were held by that PE[1038]. The French legislator reacted and amended the provision

[1035] See also M. DEYSINE DE BOURQUENEY, "Déductibilité des intérêts versés à une société-mère étrangère: une décision discutable", *Bull. Joly Sociétés* 2001, 8-9, 874.

[1036] This is not to suggest that the 2008 update could be applied to a dispute involving the 1959 Austrian/French treaty. The question is simply what the result would be in a similar case if the OECD's current approach is applied.

[1037] Before 1988, Article 145(1) CGI read as follows: *"Le régime fiscal des sociétés mères, tel qu'il est défini aux articles 146 et 216, est applicable aux sociétés françaises par actions ou à responsabilité limitée qui détiennent, dans le capital d'autres sociétés revêtant l'une de ces formes, des participations satisfaisant aux conditions ci-après […]"*. It was that version of the French legislation that was at issue in the decision of the Conseil d'Etat in *SAS France* (16 February 1990, *RJF* 4/90 No. 393), discussed briefly in 2.E.II. The taxpayer's claim in that case failed because it was based on the nationality non-discrimination clause while the French rules clearly do not discriminate on the basis of nationality.

[1038] Conseil d'Etat 18 November 1985, No. 50643, discussed in 2.D.II.B.a.5.

in question. As a result of that amendment, a company qualified as a ‘parent company’ if it was subject to corporation tax in France at the normal rate, i.e. if it was established in France or if it had a PE there which held the shares (or, alternatively, if it carried out a taxable activity in France).

The deduction was only denied if both conditions were met cumulatively, i.e. if the parent company was a non-resident **and** if that parent company did not have a PE in France nor carried out any taxable activity there. Thus, if the Commentary is interpreted literally, Art. 24(5) OECD MC cannot be applied to a situation such as that at issue, since the distinction is not made **solely** on the basis of foreign ownership **but also** on the basis of the foreign owner not having a PE nor exercising a taxable activity in France.

As argued in 2.F.I.C.b, however, the analysis under Art. 24(5) is less narrow. For the application of that provision, it is irrelevant that the distinction is **also** based on another criterion. Instead, it is sufficient that there is a necessary link between foreign ownership and the disadvantage. In order to verify whether that is the case, it is advisable to start with the comparability-test, rather than simply consider whether the domestic rule formally distinguishes on the basis of the prohibited criterion. Accordingly, it is necessary to first construct the appropriate subject and object of comparison. The subject of comparison is a resident enterprise with a non-resident parent company. The object of comparison is a resident enterprise with a resident parent company.

The comparison made by the Conseil d’Etat was between the taxpayer, i.e. the resident subsidiary of the Austrian parent company, and the resident subsidiary of a company qualifying as a ‘parent company’ under French domestic law. Having regard to its form and the nature of its activities, the Austrian company would have been subject to corporation tax at the normal rate in the tax years at issue if it had exercised its activity in France, even though it did not have a PE in France. Therefore, it would have qualified as the ‘parent company’ of the taxpayer under French domestic law if it had exercised its activities in France. For that reason, the Conseil d’Etat held that the taxpayer was comparable to the resident subsidiary of a company qualifying as a ‘parent company’ under French domestic law[1039].

That is a remarkable line of reasoning. The Conseil d’Etat points out that the Austrian company would have qualified as a ‘parent company’ under domestic law **if** it had exercised its activity in France. For that reason, the Conseil d’Etat concludes that the resident subsidiary of that Austrian company is comparable to the resident subsidiary of a company qualifying as a ‘parent company’ under French domestic law. In other words, the subject of comparison is the resident subsidiary of an Austrian company (the latter not being subject to French corporation tax in the absence of a French PE and French activities), while the object of comparison is the resident subsidiary of a company qualifying as a ‘parent company’ under French domestic law. Thus, the object of comparison is the resident subsidiary of (1) a

[1039] Conseil d’Etat 30 December 2003, No. 233894, 6 *ITLR* 609-610: *“si elle avait exercé son activité en France, [Andritz] aurait, compte tenu de sa forme et de la nature de cette activité, été soumise à l’impôt sur les sociétés au taux normal […]; qu’elle aurait ainsi revêtu, en application de l’article 145 du code général des impôts et au regard de sa filiale française […] la qualité de société mère; que, par suite, cette filiale doit être regardée […] comme étant de même nature, au sens de l’article 26 § 3 précité de la convention […], que la filiale française d’une société détenant la qualité de société mère au sens de l’article 145 du code général des impôts”*. Since there is no indication as to the exact meaning of *“de même nature”* in the Austrian/French treaty, it is assumed here that that expression has the same meaning as ‘similar’ in Art. 24(5) OECD MC.

resident company, (2) a non-resident company with a PE in France, or (3) a non-resident company that exercises its activities in France.

Clearly, that is not the correct comparison under the ownership non-discrimination clause. Instead, the comparison should be made between the French subsidiary of the Austrian parent and a similar French subsidiary of a French parent[1040]. It could then be argued that those categories are incomparable because the French parent company is subject to French corporation tax at the normal rate, while the Austrian parent is not. If that is a relevant characteristic, the situations are incomparable because that characteristic is not inextricably linked to the comparative attribute[1041]. That is to say, the characteristic in question, i.e. the parent company's non-liability to French corporation tax at the normal rate, is not inextricably linked with the parent company's non-residence, because there are also non-resident companies that are liable to French corporation tax at the normal rate, namely if they have a PE in France or carry out their activities there.

The decisive question therefore is whether the parent company's liability to French corporation tax at the normal rate is a relevant characteristic in the context of the domestic rules at issue. The purpose of domestic thin cap rules is to avoid that the domestic tax base is eroded because profits are shifted abroad. From the perspective of that purpose, it is clear that the parent company's liability to French corporation tax is a relevant characteristic: the risk of erosion of the French tax base is only avoided if the payments in question are taxable in France, i.e. if the parent company is subject to corporation tax in France (either because it is established there, because it has a PE there or because it carries out activities there). As a result, parent companies not subject to corporation tax in France are not comparable to resident parent companies, which means that the French rules at issue did not give rise to discrimination contrary to Art. 24(5).

3. Relationship to Arts. 9(1) and 11(6)

Another interesting aspect of this case is that the applicable tax treaty contained provisions that were identical in substance to Arts. 9(1) and 11(6) OECD MC, namely Arts. 6(5) and 17(A)(4) of the treaty[1042]. The tax authorities argued that those provisions precluded the non-

[1040] In a preceding paragraph, the Conseil d'Etat did make the comparison with the French subsidiary of a French company (Conseil d'Etat 30 December 2003, No. 233894, 6 *ITLR* 609: *"il résulte de l'article 26 § 3 de la convention franco-autrichienne que la filiale française d'une société mère autrichienne doit […] être regardée comme étant de 'même nature', au sens de cette stipulation, que la filiale française d'une société mère française, non seulement dans le cas où la société mère autrichienne disposerait en France d'un établissement stable qui détiendrait ou contrôlerait lui-même tout ou partie du capital de la filiale et serait imposé en France à l'impôt sur les sociétés au taux normal, mais encore, en l'absence d'un tel établissement, dans le cas où ladite société mère aurait elle-même été passible en France de cet impôt au même taux, si elle avait exercé son activité sur ce territoire"*). However, that comparison was made in a different context. In particular, that paragraph was concerned with the question whether the Administrative Court of Appeal's interpretation was correct. Because the Conseil d'Etat held that it was not, it subsequently addressed the merits of the case itself (see supra, on Article L821-2 Code de Justice Administrative). And when it eventually considered the merits of the case, the Conseil d'Etat made the comparison discussed here, i.e. with the French subsidiary of a company qualifying under French domestic law as a 'parent company'.
[1041] See the flowchart in Part I, B.II.
[1042] Art. 6(5) of the 1959 Austrian/French treaty provided: *"Where an enterprise set up in one of the two States, by virtue of its participation in the management or capital of an enterprise set up in the other State, grants or imposes upon the latter in their commercial or financial relations conditions which differ from those which would have been made with an independent enterprise, all profits which would normally have appeared in the balance sheet of one of the enterprises but which have been transferred in the above manner to the other enterprise may, notwithstanding the legal remedies available and the mutual agreement procedure laid down in*

discrimination clause from applying. In support of this argument, the tax authorities referred to the OECD Commentary, where it is stated that Art. 9(1) does not prevent the application of domestic thin cap rules that operate on an arm's length basis and that Art. 24(5) does not apply to such domestic rules[1043]. According to the French tax authorities, the domestic rules at issue were intended to prevent thin capitalization by allowing the tax authorities to assimilate the international transactions of a multinational group to conditions that would have applied between independent enterprises.

In response to this argument, the Conseil d'Etat first held that the OECD Commentary on Art. 9(1) could not be used because the tax treaty provisions at issue predated that Commentary[1044]. Secondly, both Art. 6(5) of the treaty and Art. 9(1) OECD MC referred only to the commercial or financial 'conditions' made or granted between related enterprises. According to the Conseil d'Etat, those provisions allow a contracting State to assess the normal character of the interest on a loan granted by a resident to a resident of the other contracting State belonging to the same group, by comparing it to the interest that would have been agreed by two independent enterprises. However, those provisions did not allow a contracting State to assess the normal character of the choice made by an enterprise to finance the activity of another enterprise which it owns or controls by granting a loan in preference to the injection of capital. For that reason, these provisions did not prevent the application of the non-discrimination clause[1045].

As discussed in 2.E.IV.A, the current majority interpretation is that Art. 9(1) OECD MC does not preclude the application of domestic thin cap rules (including rules based on a fixed debt/equity ratio) if they do not go further than reducing the loan to conditions that are at arms's length. As to the relationship between Art. 24(5) and Art. 9(1), reference can be made to what was said earlier: a contextual interpretation requires that relationship to be the same as the relationship between Art. 24(4) and Art. 9(1). Accordingly, rules that are compatible with Art. 9(1) cannot be said to infringe Art. 24(5).

> On the day of its decision in *Andritz*, the Conseil d'Etat decided in a different case that the French thin cap rules fell foul of the freedom of establishment[1046]. The Conseil d'Etat held that it followed from the ECJ's interpretation of the freedom of establishment that Member

Article 25, be added to the profits of the first-mentioned enterprise which are subject to taxation." Apart from referring to 'créancier' instead of 'bénéficiare effectif', Art. 17(A)(4) was identical to the French-language version of Art. 11(6) OECD MC.

1043 Comm. OECD on Art. 9, para. 3 and Comm. OECD on Art. 24, para. 58 (which, before 2008, provided that Art. 24(5) does not apply to cases of thin capitalization because of the more specific nature of Art. 24(4): see supra).

1044 The 1959 version of the treaty already contained Art. 6(5), i.e. the provision that is similar to Art. 9(1) OECD MC. Art. 17(A)(4) (i.e. the provision similar to Art. 11(6) OECD MC) and Art. 26(3) (the ownership non-discrimination clause) were added in 1970.

1045 The Commissiare du Gouvernement had reached a similar conclusion. According to the Commissaire, Art. 9(1) only compared the conditions made between associated enterprises in their commercial or financial relations to the conditions that would have been made between independent enterprises. The provision did not mention the issue of thin capitalization, which relates to the choice of a parent company to finance its subsidiary either with debt or with capital. As regards a loan, the term 'conditions' as it is used in Art. 9(1) only relates to the amount of interest, the duration of the loan and the modalities of repayment. That term does not relate to the question as to whether to grant a loan or the choice of a different financing method. For that reason, the Commissaire argued that the provision only allowed the tax authorities to deny the deductibility where, for instance, excessive interest payments were made between related enterprises as compared to an arm's length interest that would apply between independent parties. Art. 9(1) did not allow the authorities to do so in cases of thin capitalization (Conclusions du Commissaire du Gouvernement Bachelier, 6 *ITLR* 624-628).

1046 Conseil d'Etat 30 December 2003, No. 249047, *Coréal Gestion*, 6 *ITLR* 582.

States are precluded from distinguishing between resident companies according to whether their parent companies are resident or not if the subsidiaries are comparable for the purposes of the measure at issue. According to the Conseil d'Etat, the fact that a company does not qualify as a 'parent company' within the meaning of French domestic law for the sole reason that it does not have an establishment in France does not mean that its French subsidiary is incomparable to the French subsidiary of a company qualifying as a 'parent company'. Consequently, there was an infringement of the freedom of establishment if France subjected the former to less favourable tax treatment[1047]. Unfortunately, the Conseil d'Etat in *Andritz* does not refer to the parallel issue under the freedom of establishment so it is unclear whether the ECJ's case law had any effect on the decision under Art. 24(5).

G. Article 24(6): taxes covered

I. General

Article 24 OECD MC applies to taxes of every kind and description, that is to say, including taxes not on capital or income. Art. 2 OECD MC is thus expressly superseded by Art. 24(6) OECD MC. For instance, the French Supreme Court confirmed this extended scope of application, by holding that the non-discrimination provision in the treaty between France and Switzerland applied to registration fees ('droits d'enregistrement') on the transfer of immovable property[1048]. Similarly, the Lower Tax Court of Düsseldorf applied the non-discrimination provision to the German capital tax on corporate contributions ('Gesellschaftsteuer')[1049].

The final paragraph of Art. 24 was introduced by OEEC Working Party No. 4 after a suggestion made by the Swiss Delegation, but it is not made clear why it was considered that the non-discrimination clause required such a broad scope. The OEEC documents only point out that *"the Article proposed by the Working Party relates to taxes on income, on capital, on estates and inheritances and on gifts. The Swiss Delegation has suggested that this limitation should not be maintained but that taxes and contributions in general should be covered […] In principle, the Working Party's view is that the aim should be to prevent discriminatory treatment in relation to all taxes whatever"*[1050]. In the Working Party's final report, it was simply stated that Art. 24(6) *"does not call for any special comment"*[1051]. Thus, it seems that the Working Party considered all forms of tax discrimination equally detrimental to

---

1047 Conseil d'Etat 30 December 2003, No. 249047, *Coréal Gestion*, 6 *ITLR* 585-586: *"il résulte de l'interprétation donnée de ces stipulations par la Cour de justice des Communautés européennes qu'est de nature à constituer une telle restriction l'application par un Etat membre d'un traitement fiscal inégal aux sociétés filiales constituées sur son territoire en conformité de sa législation selon que leur société mère s'y trouve ou non, elle-même, établie, dès lors qu'au regard de l'objet de l'impôt en cause, les unes et les autres de ces sociétés filiales sont dans une situation objectivement comparable. […] La cour administrative d'appel n'a pas commis d'erreur de droit en jugeant que la circonstance qu'en seule raison de ce qu'elle n'a pas d'établissement en France, une société ne se trouve pas soumise au régime fiscal français des sociétés mères n'est pas de nature à caractériser l'existence, entre une société filiale constituée par elle en France et les sociétés filiales françaises de sociétés établies en France et soumises audit régime, d'une différence de situation objective telle que cette société filiale puisse, sans qu'il en résulte une restriction à la liberté d'établissement […], se voir appliquer un traitement moins favorable en vue de la détermination des bases d'impôt sur les sociétés dont elle est redevable"*.

1048 Cour de Cassation 9 November 1993, No. 91-17.373.

1049 Lower Tax Court of Düsseldorf 30 March 1973, *Entscheidungen der Finanzgerichte* 1973, 508, discussed in *European Taxation* 1973, 430.

1050 FC/WP4(57)2, 1.

1051 FC/WP4(58)1, 9.

international trade and did not want to restrict the scope of application of the non-discrimination provision to a specific type of tax.

During the discussion preceding the 2008 update to the OECD MC and Commentary, it was proposed to emphasize in the Commentary that Art. 24 OECD MC applies to all taxes, and not only income taxes. However, the Working Group concluded that Art. 24(6) OECD MC left no doubt as to the broad scope of the provision and further noted that that broad scope would be emphasized by the addition of the examples in proposed paragraphs 11.6 and 11.7 of the Commentary (now para. 22 and 23 Comm. OECD on Art. 24)[1052].

Greece, Ireland, Luxembourg and the U.K. reserve the right to restrict the scope of the non-discrimination Article to the taxes covered by the convention[1053]. The U.K. generally exercises this right, but has not always done so. In the latter case, however, it should be noted that a taxpayer seeking to enforce in the U.K. courts a tax treaty non-discrimination provision involving a tax not covered by the treaty would have to show that the provision has been incorporated into U.K. domestic law. As indicated earlier (cf. supra 2.B.VII.C), this will not always be the case.

II. Case law

II.A. Dutch Supreme Court 1 November 2000

a. The Court's decision

The Dutch Supreme Court was asked to rule on the importance of Article 24(6) (or rather, the importance of its absence)[1054]. The facts of the case were substantially similar to those in the three similar Supreme Court cases of 27 April 1994, discussed in 2.F.II.D.c. Unlike those three cases, however, the present case concerned the Canadian/Dutch treaty, which did not include a provision similar to Art. 24(6) OECD MC.

A Canadian parent company set up a subsidiary in the Netherlands. The subsidiary issued shares to the Canadian parent, which, in return, transferred all of the shares in its Swiss subsidiary. The Dutch tax authorities assessed the Dutch subsidiary to capital duty. If the contributor, i.e. the parent company, had been established in the Netherlands or another Member State, the transaction would have been exempt from capital duty. The taxpayer argued that this constituted discrimination contrary to the ownership non-discrimination provision of the Canadian/Dutch treaty[1055].

The Court of Appeal held in favour of the taxpayer. Even though the treaty did not contain a provision similar to Art. 24(6) OECD MC, the Court pointed out that the ownership non-discrimination provision prohibited discrimination with respect to 'any taxation'. According

[1052] OECD, "Application and interpretation of Article 24 (non-discrimination). Public discussion draft", 3 May 2007, 27.
[1053] Comm. OECD on Art. 24, para. 92.
[1054] Hoge Raad 1 November 2000, no. 35398, *BNB* 2001/19c.
[1055] Art. 24(3) of the 1986 which, for the purposes of the present discussion, is identical to Art. 24(5) OECD MC. The only relevant difference is that the object of comparison under the Canadian/Dutch treaty is a resident company, the capital of which is owned or controlled *"by one or more residents of a third State"*. Unlike Art. 24(5) OECD MC, this provision is a most-favoured nation clause rather than a pure non-discrimination clause. However, this deviation made no difference in the case at hand since the exemption applied where the contributor was established in the Netherlands or in any other Member State.

to the Court of Appeal, the difference in wording between Art. 2(1) of the treaty, which only referred to 'taxes on income'[1056] and the non-discrimination provision, which referred to 'any taxation' could not be a coincidence or a mistake. The Court therefore held that the drafters of the treaty intended for the non-discrimination provision to cover other taxes, apart from taxes on income. As a result, that provision also applied to the capital duty in the present case.

The tax authorities appealed against that decision to the Supreme Court, which allowed the appeal. The Supreme Court pointed out that the treaty, according to its title and according to Article 2, only applied to taxes on income. As a result, the Court held that the words 'any taxation' in the non-discrimination provision only referred to such taxes on income. Even though that expression, considered separately, could be interpreted as referring to all taxes without any restriction, the Court observed that Article 31 VC required a treaty to be interpreted *"in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose"*. The Supreme Court therefore held that, in order to determine the ordinary meaning of an expression used in a treaty provision, it was necessary to consider the treaty **as a whole**, rather than considering the provision separately. In the present case, it was clear that the object and purpose of the treaty **as a whole** were restricted to taxes on income. Interpreting a treaty provision in a broad manner which expands the treaty's scope of application would frustrate the 'ordinary meaning' of the terms used in Art. 2. The Supreme Court thus concluded that the non-discrimination provision did not apply to the capital duty.

Additionally, the Court pointed out that the treaty did not include a provision similar to Art. 24(6) OECD MC. Even though that circumstance was not decisive because treaty practice varied as to the inclusion of such a provision, the Court nevertheless held that it supported the conclusion that the treaty partners intended for the ownership non-discrimination clause not to apply to capital duty.

b. Analysis

The Advocate-General had reached a different conclusion. He first pointed out that there were a number of other treaties, apart from the treaty with Canada, which did not include a provision similar to Art. 24(6) OECD MC. The Advocate-General then refers to Article 31 VC, and points out that a textual and grammatical interpretation of the treaty should be the first step in the analysis. Other interpretation methods should only be used if the literal text of the provision, interpreted in accordance with the ordinary meaning of its terms, leads to unclear or absurd results. According to the Advocate-General, a textual and grammatical interpretation of the ownership non-discrimination clause in the Canadian/Dutch treaty implies that the provision covers **all taxes**. He does not find any support for the argument that 'any taxation' in that provision should be interpreted as 'any taxation referred to in Art. 2'.

The Advocate-General then addresses the absence of a provision similar to Art. 24(6) OECD MC from the treaty. According to the Advocate-General, that provision only served to remove doubts as to the scope of application of the non-discrimination provision. In other words, when the expression 'any taxation' is used in the non-discrimination provision, that is sufficient in itself to conclude that it applies to taxes of every kind. Provisions similar to Art. 24(6) OECD MC are only added to stress this. In the present case, the tax authorities had

[1056] In this respect, the Canadian/Dutch treaty deviates from Art. 2(1) OECD MC, which refers to *"taxes on income and on capital"*. However, the issue would not have been different had the treaty followed the OECD MC, since the capital duty could not be considered as a 'tax on capital'.

acknowledged that no such provision was included in the treaty because Canada wanted to restrict the scope of application of the non-discrimination provision to federal taxes. But that did not mean that the treaty partners intended to exclude the Dutch capital duty from the scope of that provision. According to the Advocate-General, the object and purpose of the non-discrimination provision opposed a restrictive interpretation. The absence of a clause similar to Art. 24(6) OECD MC did not alter that conclusion[1057].

The Advocate-General's line of reasoning is not entirely convincing[1058]. By concluding that the expression 'any taxation' in the non-discrimination provision implies that the provision should apply to taxes of every kind and description, notwithstanding the provisions of Art. 2, Art. 24(6) OECD MC is rendered meaningless as regards Art. 24(1), (2) and (5) OECD MC.

As pointed out by the Supreme Court, the ordinary meaning of the expression 'any taxation' considered separately can indeed be understood as referring to taxes of every kind. However, Art. 31 VC requires the terms of a treaty to be interpreted **in their context**. Clearly, the context of a treaty provision includes the other provisions of that treaty[1059]. Consequently, the expression 'any taxation' as it is used in the non-discrimination provision should be interpreted in accordance with the definition of 'taxes' in Art. 2. The addition of the word 'any' does not expand the scope of the provision to cover other taxes than those mentioned in Art. 2. That word rather forms part of the prohibition *"not to impose any taxation"* which is other or more burdensome. Otherwise, it would be unclear why the word 'any' is also used before 'connected requirements' in Art. 24(1) and (5). Additionally, the object and purpose of the non-discrimination provision do not alter this conclusion. Art. 24(5) is intended to protect a company which is owned or controlled by residents of the other contracting States from tax discrimination as compared to domestically-owned companies (see supra). There is nothing in that objective to suggest that the 'tax discrimination' in question concerns all types of taxes. Indeed, it would seem more logical that the objective of the provision is to prohibit discrimination in matters where the treaty applies, that is to say, in respect of taxes referred to in Art. 2.

That being said, the case before the Supreme Court was perhaps less straightforward. As pointed out by the Advocate-General, the reason why Art. 24(6) was not included in the Canadian/Dutch treaty was that Canada wanted to ensure that the non-discrimination provision would only apply to federal taxes. If that is indeed the case, then it could be argued that the treaty partners' intended for the non-discrimination clause to apply to all taxes, **apart from non-federal taxes**. In other words, the treaty partners wanted that clause to apply to the capital duty. That element could then be taken into account when determining the object and purpose of the non-discrimination provision, for the purposes of interpreting the expression 'any taxation'.

Yet, that does not mean that Art. 24(6) is meaningless as regards Art. 24(1), (2) and (5) on the basis that the expression 'any taxation' in those clauses implicitly refers to 'taxes of every kind and description, notwithstanding the provision of Art. 2'. As pointed out above, that

[1057] Opinion of Advocate-General Wattel in Hoge Raad 1 November 2000, no. 35398, *BNB* 2001/19c, paras. 6.4 *et seq*.
[1058] *Contra*: R. OFFERMANS, "Non-discrimination clause in Canada-Netherlands tax treaty not applicable to capital duty", *European Taxation* 2001, 108, who agrees with the Advocate-General that *"a non-restrictive interpretation would be more in line with the purpose and intention of the tax treaty"*.
[1059] Art. 31(2) VC. See, in general, F. ENGELEN, *Interpretation of tax treaties under international law*, Amsterdam, IBFD, 2004, 186 *et seq*.

interpretation is neither supported by the text of the treaty, nor by the object and purpose of the provision. It is therefore necessary to determine in each case why the treaty does not include a provision similar to Art. 24(6). And if there is nothing to suggest that the treaty partners intended for the non-discrimination provision to apply to all types of taxes, despite the absence of Art. 24(6), there is no reason to expand the scope of application of that provision beyond the framework determined in Art. 2 of the treaty.

H. The concurrent application of different provisions of Art. 24 OECD MC

Because the paragraphs of Art. 24 OECD MC all relate to very specific situations, the issue of interaction between the different paragraphs arises only rarely. As a result of their specific scope, questions as to the possible concurrent application of the different non-discrimination clauses of one tax treaty are to a significant extent theoretical. Nevertheless, these questions present some challenging issues.

Hereafter, the possible combinations of the different clauses will be explored. As a preliminary note, it should be recalled that the relationship between Art. 24(4) and (5) was already addressed earlier, in the context of domestic thin cap rules (see 2.F.IV).

I. Article 24(1) and Article 24(3)

It is possible that a non-national invokes not only Art. 24(1) but also another non-discrimination clause of the tax treaty in order to claim certain tax benefits in the other contracting State. However, it is immediately clear that a concurrent application of Art. 24(1) and (2) is impossible. Since Art. 24(2) only applies to stateless persons while Art. 24(1) only applies to nationals of one of the contracting State, it is impossible for a taxpayer to find himself within the scope of application of both provisions at the same time.

The concurrent application of Art. 24(1) and (3) is more likely, namely where the taxpayer is a national resident of State A with a PE in State B[1060]. First, assume that the domestic measure grants tax benefits exclusively to State B nationals. Applying Art. 24(1) would mean that the subject of comparison is compared to a national of State B who is in the same circumstances with respect to residence, i.e. a national non-resident of State B. Since the object of comparison is entitled to the benefit while the subject of comparison is not, there is clearly discrimination contrary to Art. 24(1).

Can Art. 24(3) also be applied here? Under that provision, the appropriate object of comparison would be a resident of State B carrying on the same activities as the taxpayer's PE. However, because nationality is a relevant characteristic in the context of the domestic measure at issue, the object of comparison would also have to be a non-national (i.e. in the same circumstances with respect to nationality). Since the object of comparison – a non-national resident of State B carrying on the same activities as the taxpayer's PE – is not

[1060] For an example, see the *Saipem* case, discussed in 2.B.V.B.f and 2.D.III.C.a.4.

entitled to the benefit either, there is no discrimination contrary to Art. 24(3)[1061]. In other words, there is no actual concurrent application of the two provisions.

Secondly, if the domestic measure grants benefits exclusively to State B residents, the State A national with a PE in State B can successfully rely on Art. 24(3) to challenge that distinction. Under that provision, the comparison should be made with a State B resident who carries on the same activities as the taxpayer's PE. Since nationality is not a relevant characteristic, it should not be considered in the comparability-test. Consequently, there is discrimination contrary to Art. 24(3).

Could the taxpayer also rely on Art. 24(1)? Since Art. 24(1) prohibits discrimination of nationals of one contracting State as compared to nationals of the other contracting State who are in the same circumstances with respect to residence, the appropriate comparison under that provision is with a non-resident national of State B. That object of comparison is not entitled to the benefit either, which means that there is no discrimination. Once again, it cannot be said that the two provisions apply concurrently.

Finally, what happens if the domestic measure grants benefits exclusively to resident nationals of State B? If the above analysis is followed, the appropriate comparison under Art. 24(1) is with a non-resident national of State B (since residence is a relevant characteristic). Since that object of comparison is not entitled to the benefit either, there is no discrimination. On the other hand, the appropriate comparison under Art. 24(3) is with a non-national resident of State B carrying on the same activities (since nationality is a relevant characteristic). Since that object of comparison is not entitled to the benefit either, there is no discrimination. Obviously, that result is difficult to reconcile with the clear wording and the purpose of the non-discrimination clause (see infra).

II. Article 24(1) and Article 24(4)

Similar issues arise where the relationship between Art. 24(1) and 24(4) is concerned[1062]. Here, the subject of comparison is a non-national resident of State A who, while carrying on an enterprise in State A, makes payments to a resident of State B. First, assume that the domestic rule allows residents to deduct certain payments only if they are made by nationals. Clearly, such a measure would infringe Art. 24(1), while Art. 24(4) cannot be applied (nationality being a relevant characteristic; see supra).

Conversely, where the domestic measure allows residents to deduct payments only if they are made to other residents, the measure falls foul of Art. 24(4). Under Art. 24(1), the comparison would then be with a national resident who makes a payment to a non-resident (the recipient's place of residence being a relevant characteristic). Since the object of comparison is not entitled to the benefit either, there is no discrimination contrary to Art. 24(1).

[1061] This argument, and the remainder of the analysis concerning the relationship between Art. 24(1) and Art. 24(3) applies *mutatis mutandis* to the relationship between Art. 24(2) and 24(3). Indeed, it is possible that a stateless person is a resident of State A and carries on business in State B through a PE.
[1062] Once again, the arguments developed here apply *mutatis mutandis* to the relationship between Art. 24(2) and 24(4), i.e. where a stateless person residing in State A and carrying on an enterprise in that State makes a payment to a State B resident.

Finally, what if the domestic measure allows deductibility exclusively for resident nationals making a payment to another resident? The comparison under Art. 24(1) would then be with a resident national making a payment to a non-resident (the recipient's place of residence being a relevant characteristic) while the comparison under Art. 24(4) would be with a non-national resident making a payment to another resident (nationality being a relevant characteristic). Since the object of comparison in neither analysis is entitled to the benefit, there is no discrimination. So a separate application of the provisions is to no avail (see infra).

III. Article 24(1) and Article 24(5)

The simultaneous application of Art. 24(1) and Art. 24(5) would require a non-national to be treated less favourably than a national **and** a foreign-owned resident enterprise to be treated less favourably than domestically-owned resident enterprises[1063]. In theory, two scenarios are possible where that would be the case: either Art. 24(1) is applied to the foreign parent while Art. 24(5) is applied to the resident subsidiary, or both Art. 24(1) and 24(5) are applied to the resident subsidiary.

First, assume that Art. 24(5) is applied to the resident subsidiary while Art. 24(1) is applied to the foreign parent. That is to say, assume that the foreign-owned resident is discriminated against as compared to a domestically-owned resident in contravention of Art. 24(5) while the foreign parent is at the same time discriminated against on the basis of nationality in contravention of Art. 24(1). As pointed out in 2.F.II.C, Art. 24(5) requires that all relevant circumstances, apart from the residence of the taxpayer's shareholder, must be identical. Accordingly, the comparison is between a resident company owned by a non-resident and a resident company owned by a resident. All other relevant characteristics must be the same. It seems likely that the nationality of the parent company is irrelevant as regards domestic tax measures that take account of the relationship between two resident companies. In the unlikely event that the parent company's nationality turns out to be relevant, it should nevertheless be disregarded if it is inextricably linked with that parent company's residence.

Moreover, apart from being a non-resident (which is necessary in order for Art. 24(5) to apply), the parent company must also be a non-national in order for Art. 24(1) to apply. As discussed in 2.B.V.A, the subject of comparison and the object of comparison under Art. 24(1) must be *"in the same circumstances in particular with respect to residence"*. Thus, the comparison under Art. 24(1) is between the non-national parent company and a national company which is in the same circumstances with respect to residence, that is to say, a national non-resident parent company.

Therefore, in order for the two provisions to apply at the same time, it is necessary that the resident subsidiary of a non-resident, non-national parent company is treated less favourably than the resident subsidiary of a resident parent company[1064], while the non-resident, non-national parent company is at the same time treated less favourably than a non-resident

[1063] It should be noted that the concurrent application of Art. 24(2) and 24(5) is impossible, since the latter provision does not apply to individuals while Art. 24(2) applies exclusively to individuals (see 2.C.II).
[1064] Assuming that the parent company's nationality is irrelevant. If it is not, it should be ascertained whether its nationality is inextricably linked with its residence. If that is not the case, the situations are incomparable, meaning that there is no discrimination.

national parent company[1065]. Theoretically, that is possible, but it is clear that there is no actual concurrent application of the two clauses. Indeed, two different discriminations are at issue here. On the one hand, the foreign-owned resident subsidiary is discriminated against as compared to a domestically-owned resident subsidiary. On the other hand, the non-resident, non-national parent company is discriminated against as compared to a non-resident national parent company. Art. 24(5) should be applied to the former discrimination, while Art. 24(1) should be applied to the latter. Both issues can be resolved separately without there being any interaction between the provisions.

Secondly, assume that both Art. 24(1) and 24(5) would be applied to the foreign-owned subsidiary. For that to be possible, it is necessary, first of all, that a non-national company is treated less favourably than a national company. Secondly, that non-national company must at the same time be the resident subsidiary of a non-resident parent company and be treated less favourably than a resident subsidiary of a resident parent company. So the subject of comparison is a non-national resident subsidiary that is owned by a non-resident.

Since Art. 24(5) requires all relevant characteristics, apart from foreign ownership, to be the same, it is necessary to determine whether the foreign-owned subsidiary's non-nationality is a relevant characteristic for the purposes of the measure at issue. If it is, the subject of comparison can only be validly compared to a domestically-owned resident non-national company. If it is not, it should be disregarded in the comparability test. Generally, nationality will not be a relevant characteristic, for instance where domestic law determines nationality on the basis of the place of incorporation and the domestic tax legislation does not attach any consequences to incorporation.

Art. 24(1) also requires all relevant characteristics to be identical. So for the purposes of the comparison under this clause, it is necessary to determine whether the subject of comparison's foreign ownership is a relevant characteristic in the context of the domestic measure at issue. If it is, the comparison can only be validly made with a national foreign-owned company.

In other words, everything depends on how the domestic measure under scrutiny works. First, assume that that measure grants a benefit exclusively to domestically-owned resident companies. Can the subject of comparison, a non-national resident companies that is owned by a non-resident, then rely on Art. 24(1) to challenge that measure? Clearly, foreign ownership is a relevant characteristic for the purposes of the domestic measure at issue, so the subject of comparison cannot be compared to a domestically-owned resident. Instead, the only valid comparison is with a national foreign-owned resident. Since the object of comparison is not entitled to the benefit either, there is no discrimination contrary to Art. 24(1). On the other hand, it is clear that the subject of comparison can rely on Art. 24(5). Since nationality is not a relevant characteristic, the object of comparison is a domestically-owned resident company (irrespective of its nationality). Since the latter is entitled to the benefit while the subject of comparison is not, there is discrimination contrary to Art. 24(5).

Secondly, assume that the domestic measure grants a benefit exclusively to national companies. It is clear that Art. 24(1) would then be infringed. Since the subject of comparison's foreign ownership is not a relevant characteristic, the object of comparison is a

[1065] There is an additional issue, in that the taxation in question must result in the foreign-owned subsidiary being treated less favourably than a domestically-owned subsidiary, while at the same time resulting in less favourable treatment for the foreign parent as compared to a national company. For the sake of simplicity, it is assumed here that that is the case.

national company (irrespective of its ownership). Since the latter is entitled to the benefit while the former is not, there is discrimination contrary to Art. 24(1). Can that subject of comparison also rely on Art. 24(5)? Obviously, nationality is a relevant characteristic for the purposes of the domestic measure at issue, which means that the only valid object of comparison is a non-national resident domestically-owned company. Since that object of comparison is not entitled to the benfit either, there is no discrimination.

Finally, assume that the domestic measure grants a benefit exclusively to national companies that are owned by residents. If the above analysis is followed, the appropriate comparison under Art. 24(1) is with a national foreign-owned resident (since foreign ownership is a relevant characteristic). Since that object of comparison is not entitled to the benefit either, there is no discrimination. Furthermore, the appropriate comparison under Art. 24(5) is with a non-national domestically-owned resident (since nationality is a relevant characteristic). Since that object of comparison is not entitled to the benefit either, there is no discrimination. Once again, that result is difficult to reconcile with the clear wording and the purpose of the non-discrimination clause (see infra).

IV. Article 24(3) and Article 24(4)

A first relevant scenario in this context is where a resident of State A has a PE in State B and that PE makes a payment to a State B resident. Can it be argued that the tax treatment of the payment is governed both by Art. 24(3) and by Art. 24(4)? Clearly, that is not the case, since Art. 24(3) prohibits discrimination in the PE State (State B), while Art. 24(4) prohibits discrimination in the residence State (State A). So it cannot be said that the same tax treatment is covered by both provisions.

Conversely, where a resident of State A has a PE in State B and that PE makes a payment to another State A resident, it is clear that there may be grounds for relying on Art. 24(3) but not for relying on Art. 24(4). The latter provision requires there to be a payment from a resident of one contracting State to a resident of the other contracting State and that is not the case here.

Consequently, it seems that a concurrent application of these two provisions is impossible.

V. Article 24(3) and Article 24(5)

In order for these two provisions to apply at the same time, it is necessary that a resident of State A has a PE in State B and holds the shares in its State B subsidiary through that PE. However, it does not seem that this situation can give rise to actual issues of concurrent application of the two provisions since Art. 24(3) covers discrimination of the PE while Art. 24(5) covers discrimination of the foreign-owned subsidiary. It is possible that a domestic measure has disadvantageous effects both for the PE and for the subsidiary, but those disadvantages give rise to two different instances of discrimination which should be addressed separately: the former on the basis of Art. 24(3) and the latter on the basis of Art. 24(5).

Therefore, it seems that a concurrent application of Art. 24(3) and (5) of the same treaty is impossible.

VI. Conclusion

In those cases where two non-discrimination clauses of the same treaty can be applied simultaneously[1066], the same issue arises every time. If there is an actual concurrent application of two clauses at the same time (i.e. when the domestic measure discriminates on the basis of both prohibited criteria at the same time) it seems that a strict application of the two clauses separately leads to the result that neither clause has been infringed. Obviously, that result does not square with the clear wording and purpose of Art. 24 OECD MC. For that reason, it is submitted that, in such cases, both clauses should be applied at the same time.

Since discrimination against non-nationals is prohibited (Art. 24(1)) and discrimination against the PE of non-residents is prohibited (Art. 24(3)), it is clear that discrimination against both at the same time is prohibited as well. It is therefore necessary to apply both provisions simultaneously, instead of separately. The same goes for discrimination against non-nationals (Art. 24(1)) in combination with discrimination against outbound payments (Art. 24(4)) and for discrimination against non-nationals (Art. 24(1)) in combination with discrimination against foreign-owned enterprises (Art. 24(5)). If both provisions are applied simultaneously, the discrimination is struck down, irrespective of the fact that a separate application of the clauses would be problematic.

[1066] I.e. Art. 24(1) in combination with Art. 24(3), (4) or 24(5) and Art. 24(2) in combination with Art. 24(3) or (4).

Part III: Non-discrimination in European tax law

1. General overview of the ECJ's approach to non-discrimination

Throughout the European Treaties, several provisions refer to the principle of non-discrimination, and form specific expressions of this general principle in their respective spheres. From these specific provisions, and the way they are applied by the ECJ, it is clear that the principle of equality is one of the fundamental principles underlying EU law[1067]. Indeed, the ECJ has consistently held that the specific non-discrimination rules of the Treaty constitute *"merely a specific enunciation of the general principle of equality which is one of the fundamental principles of Community law."*[1068]

Article 18 TFEU[1069] contains the following prohibition of discrimination on grounds of nationality: *"Within the scope of application of the Treaties, and without prejudice to any special provisions contained therein, any discrimination on grounds of nationality shall be prohibited."*

The scope of Article 18 is limited, first by its non-applicability in purely domestic situations[1070] and secondly by its residual character, which means that the general prohibition on nationality discrimination will only come into play independently when none of the more specific provisions prohibiting discrimination is applicable[1071]. In other words, Article 18 states in general terms what the specific provisions state in their respective scopes. As a corollary of this 'umbrella nature' of Article 18, the ECJ has held that, when a national measure violates one of the specific expressions of the non-discrimination idea, Article 18 (as the general expression of this idea) will be violated as well[1072]. This underlines the idea set out above: there is a non-discrimination concept which permeates through the EU Treaties, and which is expressed in general terms in Article 18 and in specific terms elsewhere. Accordingly, the fact that a violation of one of the specific expressions results in a violation of

[1067] E.g. G. VAN HECKE, "La notion de discrimination", in J. SNOY ET D'OPPUERS (ed.), *Les aspects juridiques du Marché Commun*, Université de Liége, 1958, 128: *"tout le traité n'est en quelque sorte que la mise en oeuvre de ce principe fondamental de l'interdiction de discrimination en raison de nationalité."*

[1068] E.g. joined cases C-117/76 and 16/77, *Ruckdeschel v Hauptzollamt Hamburg-St. Annen*, 19 October 1977, *ECR* 1977, 1753, § 7; C-122/95, *Federal Republic of Germany v Council of the European Union*, 10 March 1998, *ECR* 973, § 62; C-125/77, *Koninklijke Scholten-Honig NV v Hoofdproduktschap voor Akkerbouwprodukten*, 25 October 1978, *ECR* 1978, 1991, § 26. On the difference between the principle of equality and the principle of non-discrimination: see Part I, B.I.

[1069] Which corresponds to the former Article 12 EC. Throughout the text, reference will be made to the TFEU, unless a reference to the EC Treaty is appropriate (e.g. in the discussion of a case where the ECJ applied the provisions of the EC Treaty).

[1070] E.g. C-44/84, *Derrick Guy Edmund Hurd v Kenneth Jones (Her Majesty's Inspector of Taxes)*, 15 January 1986, *ECR* 1986, 29, § 55.

[1071] E.g. C-305/87, *Commission of the European Communities v Hellenic Republic*, 30 May 1989, *ECR* 1989, 1461, § 13: *"[Article 18] applies independently only to situations governed by Community law in regard to which the Treaty lays down no specific prohibition of discrimination."* The acceptance of this *lex specialis*-character is also implied by Article 18 itself: *"without prejudice to any special provisions contained therein"*.

[1072] E.g. C-305/87, *Commission of the European Communities v Hellenic Republic*, 30 May 1989, *ECR* 1989, 1461, § 12: *"the general prohibition of discrimination on grounds of nationality laid down in Article [18] of the Treaty has been implemented, in regard to their several domains, by Articles [45], [49] and [56] of the Treaty. Consequently, any rules incompatible with those provisions are also incompatible with Article [18]."* Similarly, in tax matters: cf. C-311/97, *Royal Bank of Scotland*, § 20.

the general expression as well, implies that the non-discrimination concept underlying those expressions is identical.

On the other hand, if the specific expressions of the prohibition of discrimination cannot be applied, Article 18 TFEU can be applied independently. For instance, persons seeking their first employment cannot invoke the free movement of workers when claiming unemployment benefits, since the application of that freedom requires that the person in question has participated in the employment market by having exercised an occupational activity. As a result, such persons can rely on the general prohibition of nationality discrimination[1073]. Similarly, in *Schempp*, the taxpayer could not rely on the fundamental freedoms, as a result of which the ECJ verified whether the German regime at issue fell foul of the general prohibition of nationality discrimination (see 2.E.II.C.c). It should also be stressed that Article 18 only applies "within the scope of application of the Treaties". Consequently, the mere status as citizen of a Member State is not sufficient for Article 18 to be applicable. For a person to rely on that provision, it is necessary that he has, for instance, exercised his right to move and reside freely within the territory of the Member States (Article 21 TFEU). Accordingly, when a person has exercised his right to move and reside freely within the territory of the Member States, his situation falls within the scope of application of the Treaties, with the result that he is protected from discrimination by Article 18. The same is true if that person has exercised his freedom of establishment, the free movement of workers, the freedom to provide services or the free movement of capital.

Among the many provisions in the EU Treaties expressing the idea of non-discrimination in their respective scopes are the provisions on the fundamental freedoms, which are the most relevant provisions for the purpose of this study. The concepts of non-discrimination among different nationalities and free movement are heavily intertwined. Not only does the exercise of the free movement provisions entitle a person to protection from nationality discrimination (see supra), requiring equality is also essential in ensuring free movement, and protecting free movement will generally help in achieving equality among the nationalities of Europe. Nevertheless, both concepts must be distinguished, as they do not overlap entirely. The fundamental question arising from this distinction is whether the prohibition of discrimination is sufficient to ensure free movement, or whether a different approach is required (cf. infra).

Articles 34 and 35 TFEU (former Articles 28 and 29 EC) protect the free movement of goods by prohibiting quantitative restrictions on import and export, and all measures having equivalent effect. Thus, both Articles prohibit discrimination on the basis of the origin or the destination of goods in intra-EU trade. These prohibitions apply to direct tax rules as well[1074]: direct taxes which treat imported (or exported) goods less favourably, fall foul of these provisions.

Article 45 TFEU (former Article 39 EC) guarantees free movement of workers within the Union by ensuring that workers are able to take up employment in another Member State. The Article expressly states that this freedom entails *"the abolition of any discrimination based on nationality between workers of the Member States as regards employment, remuneration and other conditions of work and employment."* Furthermore, Article 7 of Regulation No. 1612/68

[1073] C-224/98, *Marie-Nathalie D'Hoop v Office national de l'emploi*, 11 July 2002.
[1074] E.g. C-18/84, *Commission of the European Communities v French Republic*, 7 May 1985, *ECR* 1985, I-1339.

indicates that this freedom entails the enjoyment of the same social and tax advantages as national workers[1075].

Article 49 TFEU (former Article 43 EC) prohibits restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State; this prohibition also applies to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.

Article 56 TFEU (former Article 49 EC) guarantees the freedom to provide services within the EU. Discrimination on the basis of the nationality or residence of the provider of the services is prohibited. Article 57 TFEU (former Article 50 EC) clarifies this freedom by indicating that the person providing a service may, in order to do so, temporarily pursue his activity in the State where the service is provided, under the same conditions as are imposed by that State on its own nationals.

Finally, Article 63 TFEU (former Article 56 EC) prohibits all restrictions (including discriminatory restrictions, obviously) on the movement of capital between Member States and between Member States and third countries.

It is remarkable that not all freedoms use the same wording to describe what they entail. In particular, it seems that certain freedoms are more prone to a restriction-based reading, whereas others are more suitable for a discrimination-based analysis. For instance, the provision on the free movement of workers expressly refers to *"the abolition of any discrimination based on nationality between workers of the Member States"*, whereas the provisions on the freedom of establishment, on the freedom to provide services and on the free movement of capital refer to the prohibition of **restrictions** on the relevant freedom. However, both the freedom of establishment and the freedom to provide services also refer to *"the same conditions as imposed by [the other Member State] on its nationals"*, which is a clear reference to nationality discrimination. As I will argue in 2.D.V.B, the four freedoms all encompass both a non-discrimination component and a non-restriction component.

Perhaps, the peculiar wording of the different provisions can be explained by their historical origins. When drafting the EEC Treaty, the inspiration for these provisions was most likely found in similar clauses contained in traditional instruments of public international law, such as Customs Union Treaties[1076]. For instance, the 'Zollvereinsvertrag' of 22 March 1833 between the German *Bundesstaaten* contained provisions dealing with the free movement of goods[1077], the free movement of persons[1078] and the free movement of capital[1079] and may

[1075] Regulation No. 1612/68 of the Council of 15 October 1968 on freedom of movement for workers within the Community.

[1076] W. PFEIL, *Historische Vorbilder und Entwicklung des Rechtsbegriffs der 'Vier Grundfreiheiten' im Europäischen Gemenschaftsrecht*, Frankfurt am Main, Peter Lang, 1998, 118 *et seq.*

[1077] Article 6: *"Mit der Ausführung des gegenwärtigen Vertrages tritt zwischen den contrahierenden Staaten Freiheit des Handels und Verkehrs und zugleich Gemeinschft der Einnahmen an Zöllen ein, wie beide in dem folgenden Artikel bestimmt werden"* and Article 7: ***"Es hören von diesem Zeitpunkte an alle Eingangs-, Ausgangs- und Durchgangs-Abgaben an den gemeinschaftlichen Landesgrenzen*** *des bisherigen Preußisch-Hessischen und des bisherigen Bayerisch Württembergischen Zollvereins* ***auf, und es können alle im freien Verkehr des einen Gebiets bereits befindliche Gegenstände auch frei und unbeschwert in das andere Gebiet eingeführt werden****, mit alleinigem Vorbehalte: a) der zu den Staatsmonopolien gehörigen Gegenstände (Spielkarten und Salz) nach Maßgabe der Artikel 9 und 10, b) der im Innern der contrahierenden Staaten gegenwärtig entweder mit Steuern von verschiedener Höhe, oder in dem einen Staate gar nicht, in dem andern aber mit Steuern belegten und deshalb einer Ausgleichungs-Abgabe underworfenen inländischen Erzeugnisse, nach Maßgabe des Artikels 11, und endlich c) solcher Gegenstände, welche ohne Eingriff in die von einem der* have served as a source of inspiration for the free movement provisions in the EEC Treaty[1080]. Similar provisions can be found in the Treaty of 25 July 1921 establishing an Economic Union between Belgium and Luxembourg[1081]. The original intention of the founding Member States probably amounted to nothing more than the achievement of national treatment of foreign nationals who moved to another Member State to exercise an economic activity there[1082]. As will become apparent below, however, this narrow non-discrimination concept (i.e. narrow, in that it was only aimed at inbound-situations and that it was only concerned with nationality as the criterion for discrimination) was abandoned already in the ECJ's early case law, in order to allow for a broader concept which served to abolish existing barriers between Member States and to further the realization of the Internal Market.

This study is concerned with the principle of non-discrimination, which underlies the general prohibition on nationality discrimination, as well as the Treaty Articles on free movement. The case law of the ECJ clearly shows that the core principle of non-discrimination is common to these specific expressions of the general principle. Non-discrimination is sometimes expressed differently depending on the relevant context (e.g. movement of capital, freedom of establishment, etc.)[1083], but throughout these different expressions, a common,

---

contrahierenden Staaten ertheilten Erfindungspatente oder Privilegien nicht nachgemacht oder eingeführt werden können, und daher für die Dauer der Patente oder Privilegien von der Einfuhr in den Staat, welcher dieselben ertheilt hat, noch ausgeschlossen bleiben müssen" (emphasis added). M. KOTULLA, *Deutsches Verfassungsrecht 1806 - 1918, Eine Dokumentensammlung nebst Einführungen*, Springer, 2005, 839-840.

1078 Article 18: *"Die contrahierenden Staaten wollen auch ferner gemeinschaftlich dahin wirken, daß durch Annahme gleichförmiger Grundsätze die Gewerbsamkeit gefördert und der Befugnis der Untertanen des einen Staates in dem anderen Arbeit und Erwerb zu suchen, möglichst freier Spielraum gegeben werde.* ***Von den Untertanen des einen der contrahierenden Staaten, welche in dem Gebiete eines anderen derselben Handel und Gewerbe treiben, oder Arbeit zsuchen, soll von dem Zeitpunkt ab****, wo der gegenwärtige Vertrag in Kraft treten wird,* ***keine Abgabe entrichtet werden, welcher nicht gleichmäßig die in demselben Gewerbsverhältnisse stehenden eigenen Untertanen unterworfen sind****"* (emphasis added), M. KOTULLA, *o.c.*, 845.

1079 Article 14 § 6: *"Es sollen aber schon jetzt die Gold- und Silbermünzen der sämtlichen contrahierenden Staaten – mit Ausnahme der Scheidemünze – bei allen Hebestellen des gemeinsamen Zollvereins angenommen und zu diesem Behufe die Valvationstabellen öffentlich bekannt gemacht werden"*, M. KOTULLA, *o.c.*, 844.

1080 See, generally, on the influence of the Zollverein on the early development of the European Communities: E. ROUSSAKIS, *Friedrich List, the Zollverein and the uniting of Europe*, Bruges, College of Europe, 1968, 113 *et seq.*

1081 Particularly Article 3: *"Sauf les exceptions prévues au présent Traité,* ***il y aura entre les pays de l'Union liberté de commerce pleine et entière****, sans entraves ni prohibitions d'importation, de transit ou d'exportation, et sans perception de droits ou taxes quelconques.* ***Les sujets d'un des Etats de l'Union*** *qui s'établissent, résident temporairement dans le territoire de l'autre Etat, ou empruntent le territoire de cet Etat, ses installations de transport par terre, par eau ou par les airs,* ***ne pourront y être soumis****, soit en raison du produit de leur agri culture, de leur commerce, de leur industrie, de leurs capitaux ou de leur travail, soit en raison des opérations agricoles, commerciales, industrielles, financières, des occupations et professions qu'ils y exercent, soit en raison du transport de leurs marchandises, de leur personne et de leurs biens,* ***à des modes de perception ou de circulation ni à des droits, taxes, tarifs, impôts ou patentes, sous quelque dénomination que ce soit, autres que ceux qui seront appliqués aux nationaux****; et les privilèges, immunités ou faveurs quelconques, dont jouiraient en matière de commerce ou d'industrie les ressortissants de l'un des pays contractants, seront communs à ceux de l'autre. […]"* (emphasis added), *Société des Nations - Recueil des Traités*, 1922, 224-226. An example of case law where this provision was applied is Belgian Supreme Court 3 November 1964, *Pas.* 1964, I, 226-227.

1082 Cf. U. EVERLING, "Vertragsverhandlungen 1957 und Vertragspraxis 1987 – dargestellt an den Kapiteln Niederlassungsrecht und Dienstleistungen des EWG-Vertrages", in E.-J. MESTMACKER (ed.), *Eine Ordnungspolitik für Europa. Festschrift für Hans von der Groeben zu seinem 80. Geburtstag*, Baden-Baden, Nomos Verlagsgesellschaft, 1987, 113 *et seq.* and 120 *et seq.*

1083 For instance, in the context of the free movement of capital, Article 58 §1 (a) refers to *"the right of Member States to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested."* The ECJ has held that this exception is to be understood as a reference to its rulings on comparability and justification prior to the introduction of this provision; cf. C-35/98, *Verkooijen*, § 43 *et seq.* In other words, fundamental core can be discerned[1084], and this core plays a vital role in the furthering of the internal market: the ECJ, in its case law, frequently uses the principle of non-discrimination to identify obstacles to the internal market. Two questions arise in this regard: what is this common, fundamental core of the non-discrimination principle, and is it an adequate tool for its purpose (i.e. the realization of the internal market as an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured)? Throughout the text, I will not distinguish between the different freedoms, but rather focus on their common, underlying non-discrimination concept.

A. The Court's Aristotelian understanding of non-discrimination

I. Overview

The concept of discrimination used by the ECJ is based on the Aristotelian concept of equality which states that *"things that are alike should be treated alike, while things that are unalike should be treated unalike in proportion to their unalikeness."*[1085] The essential concepts of the Court's approach can already be found in its very early case law in the framework of the ECSC Treaty (European Coal and Steel Community). For instance, in the 1959 case *Fonderies de Pont-à-Mousson*, the Court held that discrimination results from *"the dissimilar treatment of comparable situations."*[1086] Similarly, in 1961, in *Klöckner-Werke*, the Court stated that discrimination consists of treating *"like cases differently, thereby subjecting some to disadvantages as opposed to others, without such differentiation being justified by the existence of substantial objective differences."*[1087]

Two important clarifications to this general concept were introduced in *Barbara Erzbergbau*[1088]. First of all, the ECJ rejects the opinion that any comparison between several undertakings must take into account all the circumstances in which they are placed: such a view would *"lead to the result that an undertaking is only comparable with itself, and thus the concept 'comparably placed' and, therefore, that of 'discrimination' would become devoid of all meaning."*

Furthermore, the Court held that "*the concept of discrimination does not imply, by definition, the fact that direct damage is caused. The meaning of this concept is primarily that unequal conditions are laid down for comparable causes. The application of such unequal conditions may, it is true, bring about damage, which can then be considered as the consequence by which that discrimination may be detected. However, it would be arbitrary to reduce the concept of discrimination solely to those cases of unequal treatment in which the interested parties in fact suffer damage.*"

---

the exception articulated in this provision does not mean that the non-discrimination principle is to be applied differently as regards the free movement of capital.

[1084] It can be argued that this core principle remains the same in other fields of law as well, apart from tax law; this study, however, is limited to non-discrimination in the field of direct tax law.

[1085] Aristotle, *Ethica Nicomachea (Translated by W.D. Ross)*, London, Oxford University Press, 1925, V.3.1131a-1131b as summarized by P. WESTEN, "The empty idea of equality', *Harvard Law Review* 1982, Vol. 95, 543.

[1086] C-14/59, *Société des fonderies de Pont-à-Mousson v High Authority of the European Coal and Steel Community*, 17 December 1959, *ECR* 1959, 231.

[1087] Joined cases C-17 and 20/61, *Klöckner-Werke AG and Hoesch AG v High Authority of the European Coal and Steel Community*, 13 July 1962, *ECR* 1962, 615, 345.

[1088] Joined cases C-3 to 18/58 and C-25 and 26/58, *Barbara Erzbergbau AG and others v High Authority of the European Coal and Steel Community*, 10 May 1960, *ECR* 1960, 173, 191-192.

This general Aristotelian concept was upheld in EC case law as well. *Italian Refrigerators*[1089] is a milestone in this regard. The facts of the case can be summarised as follows. Cheap Italian refrigerators were imported in France, thereby threatening the domestic industry. The Commission had authorised France to temporarily reinstate customs duties on Italian refrigerators, in order to protect domestic producers. Italy asked the ECJ to annul the Commission's decision, arguing that the general nationality non-discrimination principle of the Treaty (see supra) had been violated because not all imports were treated alike. The Commission held that the situations were not comparable, as Italian refrigerators were noticeably cheaper than refrigerators imported from other Member States.

The Court held that *"the different treatment of non-comparable situations does not lead automatically to the conclusion that there is discrimination. An appearance of discrimination in form may therefore correspond in fact to an absence of discrimination in substance. Discrimination in substance would consist in treating either similar situations differently or different situations identically."*

The Court's Aristotelian understanding of non-discrimination is now summarised in its well-known standard formula: *"comparable situations must not be treated differently and different situations must not be treated in the same way unless such treatment is objectively justified."*[1090]

As indicated above, this general concept of non-discrimination is enunciated in specific expressions throughout the treaty, but the fundamental idea underlying these expressions is always the same[1091]. It is therefore possible to identify recurring patterns in the case law of the ECJ with regard to these different expressions. The case law with regard to the fundamental freedoms will prove to be the most interesting, as these freedoms are directly concerned with the realisation of a common market.

II. Methodology

In applying this Aristotelian understanding of discrimination, the ECJ has developed a consistent methodology in dealing with an alleged breach of the principle of non-discrimination. The Court's methodology consists of three steps.

First, it is determined whether the persons that are being compared are in a comparable situation. In order to establish whether that is the case, the Court verifies whether the characteristics that are relevant to the measure at issue are identical. If they are not, the situations are incomparable[1092].

[1089] C-13/63, *Italian Republic v Commission of the European Economic Community*, 17 July 1963, *ECR* 1963, 165.
[1090] Eg. C-106/83, *SpA v Cassa Conguaglio Zucchero and others*, 13 December 1984, *ECR* 1984, 4209, § 28.
[1091] There are, of course, differences caused by the individual characteristics of each provision, but this does not preclude that there are common concepts underlying the provisions. This is confirmed by the Court's position, referred to above, that the specific non-discrimination rules of the Treaty are merely enunciations of the general principle of non-discrimination, underlying EU law as a whole.
[1092] K. LENAERTS, "L'égalité de traitement en droit communautaire", *Cahiers de Droit Européen* 1991, 10; J. SCHWARZE, *European administrative law*, London, Sweet & Maxwell, 2006, 574 (who uses the term 'arbitrary' instead of 'irrelevant').

The second step consists of determining whether there has been a difference in treatment between the situations at issue. If there was no difference in treatment while the situations are comparable, there is no discrimination. On the other hand, if there was no difference in treatment while the situations are incomparable, there is discrimination since the Court also considers the application of the same rule to incomparable situations to constitute discrimination. Conversely, if there was a difference in treatment while the situations are comparable, there is discrimination. Finally, if there was a difference in treatment while the situations are incomparable, there is no discrimination.

In the third and final step of its analysis, the ECJ determines whether there is a justification for the discrimination. Even though this determination is, in principle, separate from the finding of discrimination (i.e. the justification-test is only carried out after it has been established that there is discrimination), the line between the justification-test and the discrimination-test as such may be difficult to see. That is to say, arguments pertaining to the justification of a discriminatory measure often have some relation to the comparability of the situations or the existence of a difference in treatment.

It is immediately apparent that the actual discrimination-test, i.e. the first two steps of the analysis, is identical to the test described in Part I, B, II. Since that test is also used in the application of Art. 24 OECD MC, the obvious question is whether the test applied by the ECJ and the test under Art. 24 OECD MC are interpreted in the same way in practice. That would mean that the only difference between the ECJ's case law in direct tax matters and the case law under Art. 24 OECD MC is the possibility to justify discrimination in the former body of case law, which is absent in the latter. A discussion of case law will reveal whether that is the case.

As a preliminary note, it should further be noted that the ECJ does not always make a clear distinction between the three different steps of its analysis. For instance, the Court sometimes does not consider the comparability of the situations but immediately verifies whether the alleged discrimination is justified. Moreover, the way in which these steps are applied may not always seem consistent at first sight. It is important to keep this in mind when determining whether there is a general principle of non-discrimination underlying the different decisions. If there is such a general principle, it can be compared to the principle developed under Art. 24 OECD MC.

It should also be stressed that the Court, before taking the three steps discussed above, first verifies whether the fundamental freedoms are applicable. In particular, for the freedoms to apply, it is necessary that the situation involves a cross-border element, that is to say, that the person claiming protection under the free movement provisions has a link with at least two Member States. By contrast, situations which are purely internal to a Member State, i.e. situations which are confined in all respects within a single Member State, do not come within the scope of application of the freedoms. The Court has held, for instance, that a purely hypothetical prospect of employment in another Member State is insufficient for entitlement to the free movement of workers[1093]. It should therefore be kept in mind that there are important limitations to the applicability of the fundamental freedoms, and that, as a result of those limitations, the freedoms are unable to ensure full equality in the internal market[1094]. In

[1093] Case 180/83, *Hans Moser v Land Baden-Württemberg*, 28 June 1984.
[1094] In this context, it is appropriate to refer to the recent *Prunus* case (C-384/09, 5 May 2011), which could be interpreted as an important decision with respect to the personal entitlement to the fundamental freedoms. In particular, because overseas countries and territories are neither Member States, nor third countries, one would

this context, reference should also be made to the ECJ's position on reverse discrimination: since the fundamental freedoms do not apply to purely internal situations, the ECJ has generally held that reverse discrimination is not precluded by those freedoms. On that issue, see 1.B.III.

B. Types of discrimination

I. Discrimination in form – discrimination in substance

In its early case law, the ECJ sometimes referred to the concepts of 'discrimination in form' (or formal discrimination) and 'discrimination in substance' (or substantive discrimination). For instance, in the *Italian Refrigerators* case, the Court stated that *"the different treatment of non-comparable situations does not lead automatically to the conclusion that there is discrimination. An appearance of discrimination in form may therefore correspond in fact to an absence of discrimination in substance. Discrimination in substance would consist in treating either similar situations differently or different situations identically."*[1095] It is not entirely clear what the Court had in mind when making this distinction[1096]. Most likely, the idea was to highlight the possibility that the prohibition of discrimination sometimes requires different treatment, i.e. when the situations are incomparable. More specifically, the argument of the Italian government in the *Italian Refrigerators* case had been that discrimination arose because the special tax was not imposed on all imports, but only on Italian imports. The Commission countered this argument by pointing out that Italian refrigerators were cheaper by far than refrigerators imported from other Member States. As the situations were different, the application of the tax to all imports would amount to discrimination (because incomparable situations must be treated differently). Thus, 'discrimination in form' apparently refers to a different treatment of two situations, without assessing whether these situations are comparable. On the other hand, 'discrimination in substance' refers to either a different treatment of comparable situations, or an identical treatment of incomparable situations[1097].

---

expect that capital movements from OCTs to a Member State are not covered by the free movement of capital (Article 47 of Council Decision 2001/822 only covers direct investments in companies established in OCTs). In *Prunus*, however, the Court applied the free movement of capital when resolving an issue involving a company established in the British Virgin Islands which had invested in a French company (but eventually the claim was dismissed because the grandfather clause of Article 64 TFEU applied to the French regime at issue). For a general discussion of legal issues surrounding overseas territories, see D. KOCHENOV (ed.), *EU law of the overseas*, Alphen aan den Rijn, Kluwer Law International, 2011.

[1095] C-13/63, *Italy v Commission of the European Economic Community*, 17 July 1963, *ECR* 1963, 165, § 4.

[1096] On the different opinions: C. TOBLER, *Indirect discrimination: a case study into the development of the legal concept of indirect discrimination under EC Law*, Antwerpen, Intersentia, 2005, 316. The debate has lost its relevance, as the ECJ no longer uses this distinction.

[1097] The ECJ seems to have drawn some inspiration from the case law of the Permanent Court of International Justice, in which a similar distinction is made between 'equality in law' and 'equality in fact'. See for instance the PCIJ judgment of 6 April 1935 in *Minority Schools in Albania*, Series A/B, no. 64, 15-19: *"the application of the same régime to a majority as to a minority, whose needs are quite different, would only create an apparent equality, whereas the Albanian Declaration, consistently with ordinary minority law was designed to ensure a genuine and effective equality, not merely a formal equality. […] It is perhaps not easy to define the distinction between the notions of equality in fact and equality in law; nevertheless, it may be said that the former notion excludes the idea of a merly formal equality […]. Equality in law precludes discrimination of any kind; whereas equality in fact may involve the necessity of different treatment in order to attain a result which establishes an equilibrium between different situations."* The Advocate-General expressly refers to this PCIJ judgment in his opinion in *Italian Refrigerators* (Opinion of Advocate-General Lagrange in C-13/63, *ECR* 1963, 165).

This distinction is misleading. As the concept of non-discrimination sometimes requires a different treatment (i.e. when the situations are different), the notion 'discrimination in form' encompasses forms of treatment which are not discriminatory (i.e. the different treatment of incomparable situations). It would therefore be misleading to refer to this broad category as 'discrimination in form'. 'Discrimination in substance', on the other hand, adds nothing to the traditional definition of discrimination. There is no difference between 'discrimination' and 'discrimination in substance'.

II. Direct – indirect discrimination

A rule which explicitly differentiates on grounds of nationality (or another prohibited distinguishing criterion) discriminates directly or overtly. Such a rule shall be struck down by the ECJ, unless it is justified on one of the limited grounds referred to in the Treaty. With regard to the free movement of persons and services, these justifications are limited to grounds of public policy, public security, public health and the exercise of public authority[1098].

However, States have been quite creative in applying other criteria of differentiation that lead to the same result as a rule that explicitly differentiates on grounds of nationality. For instance, application of the criterion of residence may in fact lead to the same result as discrimination on grounds of nationality[1099]. It is, therefore, possible that distinguishing criteria are used which are not expressly prohibited and appear to be neutral at first sight, but which lead to nationality discrimination nonetheless. These indirect or covert[1100] forms of discrimination hamper the development of the internal market just as much as directly discriminatory rules, and are therefore equally unacceptable[1101]. Thus, the ECJ has consistently held that *"the rules regarding equality of treatment forbid not only overt discrimination by reason of nationality but also all covert forms of discrimination which, by the application of other criteria of differentiation, lead in fact to the same result."*

As indicated above, direct discrimination can only be justified on the grounds expressly mentioned in the Treaty. In the case of indirect discrimination, the additional category of 'objective justifications' can be relied on. So the justification system with regard to direct forms of discrimination is closed, whereas objective justification in the context of indirect discrimination operates in an open system[1102]. A measure that is indirectly discriminatory will be justified when it relies on objective grounds other than nationality and is proportionate[1103]. No exhaustive list of possible objective grounds is available, so it is up to the Member State to try and justify the measure in question by advancing a legitimate interest worthy of protection. The measure must also be proportionate, which implies that it must be appropriate and

[1098] Art. 45(3) and (4), 51, 52 and 62 TFEU.
[1099] Eg. C-29/95, *Pastoors and Trans-Cap*, 23 January 1997, *ECR* 1997, I-285, § 17-18.
[1100] The ECJ generally uses the terms 'indirect' and 'covert' discrimination interchangeably, as referring to discrimination on the basis of criteria which are not prohibited *per se*, but which lead to nationality discrimination nonetheless. Some commentators use the term 'indirect discrimination' as specifically referring to tax rules that apply equally to resident and non-resident taxpayers but indirectly provide for residence requirements in their tax consequences. In order to avoid confusion, the terms 'indirect' and 'covert' discrimination will be used as synonyms, both referring to the definition generally applied by the ECJ.
[1101] E.g. C-152/73, *Sotgiu v. Deutsche Bundespost*, 12 February 1974, *ECR* 1974, 154, § 11; C-41/84, *Pinna v. Caisse d'Allocations Familiales de la Savoie*, 15 January 1986, *ECR* 1986, 1, § 23.
[1102] C. TOBLER, *Indirect discrimination: a case study into the development of the legal concept of indirect discrimination under EC Law*, Antwerpen, Intersentia, 2005, 316.
[1103] E.g. C-237/94, *John O'Flynn v Adjudication Officer*, 23 May 1996, *ECR* 1996, 2617, § 19.

necessary to achieve the aim pursued. For instance, a measure will be disproportionate by reason of not meeting the necessity-test when less onerous solutions are possible to achieve the aim pursued (see infra, on the rule of reason). As will be discussed elsewhere, the ECJ seems to have departed from this strict dichotomy between direct and indirect discrimination with respect to justification grounds.

> In this context, it is useful to recall that Article 54 TFEU provides that the nationality of companies formed in accordance with the law of a Member State is, for purposes of the application of the fundamental freedoms, determined by their registered office, their central administration or their principal place of business. Accordingly, discrimination on the basis of either of those criteria can be qualified as direct nationality discrimination. Since most Member States determine the fiscal residence of a company on the basis of its place of effective management (i.e. its 'central administration'), residence and nationality will often coincide. As a result, it is quite difficult in this context to distinguish between cases of direct and indirect discrimination.

III. Reverse discrimination

III.A. The Court's traditional position

The ECJ has consistently held that the Treaty does not apply to situations purely internal to a Member State[1104]. Situations where all the facts are confined within one Member State and where there is no cross-border element do not come within the scope of the fundamental freedoms[1105]. As a result, a Member State is not prohibited from treating its own nationals less favourably than nationals from other Member States insofar as there is no cross-border element[1106]. EU law does not offer a solution for this form of discrimination. It is for the national courts, faced with a question of national law, to determine whether there is any discrimination under that law and whether that discrimination must be eliminated and how[1107].

Nevertheless, in certain specific situations where a Member State discriminates against its own nationals, the Court will bring these persons within the scope of the Treaty by equating them with nationals of other Member States. This will be the case when a national of a Member State who has resided on the territory of another Member State wishes to exercise his Treaty freedoms to return to his state of origin. In this regard it is settled case law that, although the Treaty freedoms cannot be applied to purely internal situations, they nevertheless cannot be interpreted in such a way as to exclude a Member State's own nationals from the benefit of EU law where by reason of their conduct they are, with regard to their Member State of origin, in a situation which is equivalent to that of any other person enjoying the rights and liberties guaranteed by the Treaty[1108]. For instance, a Member State must recognise

[1104] For a general overview of the Court's case law in this context, see e.g. S. LEFEVRE, "The interpretation of Community law by the Court of Justice in areas of national competence", *E. L. Rev.* 2004, 29(4), 501-516.
[1105] E.g. C-204/87, *Bekaert*, *ECR* 1988, 2029; C-54/88, *Nino*, 3 October 1990, *ECR* 1990, 3537; C-515/99, *Reisch*, 5 March 2002, *ECR* 2002, I-2157.
[1106] E.g. C-379/92, *Peralta*, 14 July 1994, *ECR* 1994, I-3453, § 27.
[1107] C-132/93, *Steen*, 16 June 1994, *ECR* 1994, I-2715, § 10.
[1108] C-115/78, *Knoors*, 7 February 1979, *ECR* 1979, 399, § 24; C-61/89, *Bouchoucha*, 3 October 1990, *ECR* 1990, I-3551, § 13; C-19/92, *Kraus*, 31 March 1993, *ECR* 1993, I-1663, § 15. In this context, it is important to refer to the *Werner*-case, which concerned a German national who resided in the Netherlands (C-112/91, 26 January 1993). Werner had obtained his professional qualifications in Germany, had always practised his profession in Germany, earned all of his income in Germany and was subject to German tax law. According to the ECJ, the fact that non-residents such as Werner were taxed less favourably than German residents did not infringe the freedom of establishment since it concerned a purely internal situation. The Court held that the

a trade qualification acquired by its nationals in another Member State, as these persons are, with regard to their state of origin, in a situation which may be assimilated to that of any other person enjoying the rights and liberties guaranteed by the Treaty[1109].

The specific situation of *Knoors, Kraus*, e.a. must be distinguished from situations where a Member State restricts the exercise of a freedom by a national residing in its territory, for instance by treating a company differently by reason of its relocation abroad. These restrictions do not discriminate on the basis of nationality, but on the basis of the exercise of the Treaty freedoms: the nationals of a Member State who exercise their Treaty freedoms are treated less favourably than nationals who do not exercise these freedoms. In some of these cases, the Court tends to use the notion 'unequal treatment' instead of 'indirect discrimination' with regard to these issues (see infra, e.g. *ICI, AMID, X&Y)*. As a result, any reference to nationality discrimination is avoided. Nevertheless, as will be discussed in 2.D.V, there is no reason to analyse these cases differently from traditional cases involving discrimination on the basis of nationality.

III.B. Later evolution and criticism

In the past decade, the ECJ seems to have abandoned some of its reluctance to deal with purely internal situations. The Court has chosen to answer a number of preliminary questions that, on the facts, were purely internal to the Member State in question because the reply to the question "might be useful" to the national court. That is to say, the Court addresses the preliminary question because there is a chance that national law prohibits reverse discrimination, in which case the ECJ's interpretation of EU law is necessary for the referring court[1110]. The ECJ does not verify whether the national law governing the facts actually prohibits reverse discrimination nor does it require the referring court to demonstrate that its national law contains such a prohibition: it provides the referring court with a response to the preliminary ruling, which "might be useful" if national law does indeed prohibit reverse discrimination. In substance, this approach does not change the ECJ's traditional position that the free movement provisions do not apply in purely internal situations and, therefore, do not offer a solution for issues of reverse discrimination. The only effect of this approach is that

---

Werner-case had to be distinguished from *Knoors*, since the latter case concerned a national of the Netherlands who, having acquired his professional qualifications in Belgium, wanted to establish himself in the Netherlands. The taxpayer in *Werner*, in contrast, wanted to establish himself in his State of origin on the basis of professional qualifications and professional experience acquired in the same State. Thus, *Werner* is an example of the Court's traditional position that the interstate movement must have some economic aim in order for the freedoms to apply. Consequently, merely residing in another Member State has traditionally been insufficient for falling within the scope of the free movement provisions. However, the Court has not been consistent in this respect and has also applied the free movement provisions to situations where the interstate movement had no economic aim at all (e.g. C-470/04, *N*, 7 September 2006; C-212/05, *Hartmann*, 18 July 2007).

[1109] C-115/78, *Knoors*, 7 February 1979, *ECR* 1979, 399, § 24

[1110] See C-448/98, *Guimont*, 5 December 2000, *ECR* 2000, I-10663 § 23 (on the free movement of goods): *"In this case, it is not obvious that the interpretation of Community law requested is not necessary for the national court. Such a reply might be useful to it if its national law were to require, in proceedings such as those in this case, that a national producer must be allowed to enjoy the same rights as those which a producer of another Member State would derive from Community law in the same situation."* Similarly, C-515/99, Reisch, 5 March 2002, *ECR* I-02157, § 26 (concerning the free movement of capital); C-6/01, *Anomar*, 11 September 2003, *ECR* 2003, I-08621, § 41 (concerning the free movement of services). See also C. RITTER, "Purely internal situations, reverse discrimination, Guimont, Dzodzi and Article 234", *E. L. Rev.* 2006, 31(5), 696-703, who argues that the approach taken in *Guimont* is an extension of the *Dzodzi*-principle, according to which a preliminary reference is admissible where national law makes reference to provisions of EU law or where national law has made EU law applicable to domestic situations (C-Joined Cases 297/88 and C-197/89, *Dzodzi*, 18 October 1990, *ECR* 1990, I-03763).

the Court seems to have relaxed the requirements for admissibility. That is to say, the Court addresses preliminary questions that are, on the facts, purely internal, but where an interpretation of EU law may nevertheless be useful for the referring Court, assuming that national law prohibits discrimination.

That being said, it has been argued that the Court should reconsider its traditional position, given the introduction of the provisions on Union citizenship by the Maastricht Treaty[1111]. The idea behind this argument is that the Court's position on reverse discrimination starts from the assumption that purely internal situations have no sufficient link with EU law, with the result that the Treaty provisions cannot be applied. However, it has been suggested that the enjoyment of status of Union citizen in itself should be considered as a sufficient link to bring a situation within the scope of the Treaty provisions, regardless of whether the freedoms have been exercised[1112]. As a result, situations of reverse discrimination would come within the scope of the Treaty, irrespective of the exercise of the free movement rights. However, that approach has consistently been dismissed by the ECJ which has repeatedly stated that *"citizenship of the Union […] is not intended to extend the scope ratione materiae of the Treaty also to internal situations which have no link with Community law"*[1113].

Since issues of reverse discrimination should be dealt with at the national level, they will not be addressed here. Moreover, from the ECJ's point of view, these issues relate to jurisdiction rather than to substance. That is to say, the question is not *how* the Court analyses such issues of discrimination but rather *whether* it analyses them. It is submitted that those cases where the Court chooses to give a ruling on issues of reverse discrimination should be analysed in the same way as 'normal' discrimination issues.

[1111] See e.g. S. O'LEARY, *The evolving concept of Community citizenship*, London, Kluwer Law International, 1996, 277-278; A. TRYFONIDOU, "Reverse discrimination in purely internal situations: an incongruity in a citizens' Europe", *Legal Issues of Economic Integration* 2008, 43. See also N. SHUIBHNE, "Free movement of persons and the wholly internal rule: time to move on?", *C.M.L.R.* 2002, 731-771; E. SPAVENTA, "Seeing the wood despite the trees? On the scope of Union citizenship and its constitutional effects", *C.M.L.R.* 2008, 13-45.

[1112] See also Advocate-General Sharpston's Opinion in C-212/06, *Government of the French Community and Walloon Government v Flemish Government*, 28 June 2007, § 142-144: *"It seems to me that, at least potentially, the provisions on citizenship likewise challenge the sustainability in its present form of the doctrine on purely internal situations."* In particular, the Advocate-General argues that the enjoyment of the status of Union citizen in itself should be considered as a sufficient link to bring a situation with the scope of the Treaty *ratione personae*, irrespective of the exercise of the free movement rights. *"If it were to pursue this line of analysis, the Court would therefore have to decide whether on a proper construction, the 'right to move and reside freely within the territory of the Member States' in Article 18 EC means 'freedom to move and then reside' (i.e., freedom to reside derives from/flows from prior exercise of the freedom to move) or whether it means 'freedom both to move and to reside' (so that it is possible to exercise the freedom to reside/go on residing without first exercising the freedom to move between Member States)."*

[1113] Joined Cases C-64/96 and C-65/96, *Uecker and Jacquet*, 5 June 1997, *ECR* 1997, I-03171, § 23; C-148/02, *Garcia Avello*, 2 October 2003, *ECR* 2003, I-11613, § 26; C-403/03, *Schempp*, 12 July 2005, *ECR* 2005, I-06421, § 20. See also the of the ECJ's judgment in C-212/06, *Government of the French Community and Walloon Government v Flemish Government*, 1 April 2008, § 38-39 where the Advocate-General's line of reasoning referred to earlier is dismissed: *"Community law clearly cannot be applied to such purely internal situations. It is not possible […] to raise against that conclusion the principle of citizenship of the Union […] which includes, in particular, […] the right of every citizen of the Union to move and reside freely within the territory of the Member States. The Court has on several occasions held that citizenship of the Union is not intended to extend the material scope of the Treaty to internal situations which have no link with Community law"*.

IV. Quantitative restrictions and measures having equivalent effect

The various possible forms of discrimination should be distinguished from quantitative restrictions on imports and exports and measures having equivalent effect, prohibited by Articles 34 and 35 TFEU. Article 36 TFEU (former Article 30 EC) permits such restrictions and measures when they are justified on the basis of a number of listed grounds, provided that they do not constitute a means of arbitrary discrimination or a disguised restriction on trade between Member States.

The ECJ has defined 'quantitative restrictions' as *"measures which amount to a total or partial restraint of, according to the circumstances, imports, exports or goods in transit."*[1114] It is more difficult to define the scope of 'measures having equivalent effect.' In this regard, a distinction should be drawn between measures having effect equivalent to quantitative restrictions on imports and measures having effect equivalent to quantitative restrictions on exports.

The first category (Article 34 TFEU) is defined broadly in *Dassonville*[1115] as *"all trading rules enacted by Member Sates which are capable of hindering, directly or indirectly, actually or potentially, intra-community trade."* This interpretation has a much broader scope than the original interpretation by the Commission, which considered only *"measures, other than those applicable equally to domestic and imported products, which hinder imports which could otherwise take place, including measures which make importation more difficult or costly than the disposal of domestic production."*[1116] Measures applicable equally to domestic and imported products were, according to the Commission, only to be considered as measures having equivalent effect *"where the restrictive effect of such measures on the free movement of goods exceeds the effects intrinsic to trade rules. This is the case, in particular, where: the restrictive effects on the free movement of goods are out of proportion to their purpose [or] the same objective can be attained by other means which are less of a hindrance to trade."*[1117] By contrast, the broad definition given by the ECJ in *Dassonville* does encompass measures applicable without distinction to domestic and imported products. In the ECJ-interpretation, the test is no longer whether the national measure distinguishes between domestic and imported products, but whether the measure (directly or indirectly, actually or potentially) is capable of hindering the free movement of goods.

The second category, measures having effect equivalent to quantitative restrictions on exports (Article 35 TFEU), is defined by the ECJ as *"national measures which have as their specific object or effect the restriction of patterns of exports and thereby the establishment of a difference in treatment between the domestic trade of a Member State and its export trade in such a way as to provide a particular advantage for national production or for the domestic market of the State in question at the expense of the production or of the trade of other*

[1114] C-2/73, *Riseria Luigi Geddo v Ente Nazionale Risi*, 12 July 1973, *ECR* 1973, 865, § 7
[1115] C-8/74, *Procureur du Roi v. Dassonville*, 11 July 1974, *ECR* 1974, 837, § 5
[1116] Article 2 of the Commission Directive 70/50/EEC of 22 December 1969 based on the provisions of Article 33 (7), on the abolition of measures which have an effect equivalent to quantitative restrictions on imports and are not covered by other provisions adopted in pursuance of the EEC Treaty
[1117] Article 3 of the Commission Directive 70/50/EEC of 22 December 1969

Member States."[1118] As a result, measures applicable without distinction to domestic and export trade fall outside the scope of Article 35[1119].

The broad interpretation given in *Dassonville* has caused some problems. First, the grounds of justification provided by Article 36 TFEU (cf. supra) proved to be inadequate. The ECJ tried to solve this problem in *Cassis de Dijon* by allowing Member States to rely on broader grounds to justify (non-directly discriminatory) restrictions to intra-EU trade. In *Cassis de Dijon*[1120], the Court developed the so-called 'rule of reason-doctrine', according to which measures that restrict trade can be reconciled with Art. 34 TFEU (former Art. 28 EC) when they protect legitimate interests in a reasonable manner. The Court has later summarized the principles set out in *Cassis de Dijon* as follows: *"in the absence of common rules relating to the marketing of the products in question, obstacles to free movement within the Community resulting from disparities between the national laws must be accepted in so far as such rules, applicable to domestic and imported products without distinction, may be recognized as being necessary in order to satisfy mandatory requirements recognized by Community law. Such rules must also be proportionate to the aim in view. If a Member State has a choice between various measures for achieving the same aim, it should choose the means which least restricts the free movement of goods"*[1121].

It follows that the national provision in question must satisfy four requirements.

(1) Once national legislation has been harmonised, Member States may no longer rely on the rule of reason to deviate from the EU rule. The measure restricting trade can only be justified as long as there is no legislation at the EU level.
(2) The national provision must be necessary in order to satisfy mandatory requirements recognised by EU law. In the *Cassis*-judgment, the Court stated that these requirements related, *"in particular to the effectiveness of fiscal supervision, the protection of public health, the fairness of commercial transactions and the defence of the consumer."* This list is not exhaustive, as appears from the formulation which refers to these four categories "in particular." Examples of other mandatory requirements accepted by the ECJ are the protection of the environment[1122] and the protection of cultural works[1123].
(3) The national measure must be applicable without distinction to domestic and imported products, even if it is indirectly discriminatory (this will for instance be the case where it will be more difficult for imported products to conform to the measure[1124]). A measure which directly discriminates (by making a distinction between domestic and imported products) can only be justified on the grounds provided for in the Treaty. However, where the distinction is due to particular characteristics of the product, the measure ceases to be discriminatory[1125]. As a result, the non-discrimination requirement is satisfied, and the rule of reason may be applied.
(4) The national measure must be proportionate to the aim it pursues. This implies that the means which it employs must be suitable for the purpose of achieving the desired

---

[1118] C-15/79, *Groenveld BV v Produktschap voor Vee en Vlees*, 8 November 1979, *ECR* 1979, 3409, § 7
[1119] C-155/80, *Oebel*, 14 July 1981, *ECR* 1981, 1993, § 16; C-15/83, *Denkavit Nederland BV v Hoofdproduktschap voor Akkerbouwprodukten*, 17 May 1984, *ECR* 1984, 2171, § 17
[1120] C-120/78, *Rewe-Zentral AG v Bundesmonopolverwaltung für Branntwein*, 20 February 1979, *ECR* 1979, 649
[1121] C-302/86, *Commission v. Denmark*, 20 September 1988, *ECR* 1988, 4607, § 6
[1122] C-302/86, *Commission v. Denmark*, 20 September 1988, *ECR* 1988, 4607, § 9
[1123] Joined cases C-60 and 61/84, *Cinéthèque SA and others v Fédération nationale des cinémas français*, 11 July 1985, *ECR* 1985, 2605, § 23
[1124] Eg. C-261/81, *Rau v. De Smedt*, 10 november 1982, *ECR* 1982, 3961, § 13
[1125] Eg. (with regard to waste) C-2/90, *Commission v. Belgium*, 9 July 1992, *ECR* 1992, 4431, § 34

objective and must not go beyond what is necessary to achieve it. Consequently, if a Member State has a choice between different measures to attain the same objective, it should choose the means which least restricts the free movement of goods. This also implies that a Member State wishing to justify a measure restricting trade must prove that the aim pursued by the national provision is not already achieved by the legislation in force in the Member State of origin of the imported product. The burden of proof requires the Member State to show why its own situation differs so much from that of other Member States as to necessitate a specific measure[1126].

Apart from developing this so-called 'mandatory requirement doctrine', the *Cassis*-judgment was highly important in that it also laid down the 'principle of mutual recognition': Member States recognise each other's regulations, which allows products to flow freely through the EU, as each product can gain access to the other Member States' market without having to be modified. The combination of these two ideas implies that once goods have been lawfully produced in a Member State, they should be able to circulate freely in the EU, unless there is a valid reason to stop them. Only a mandatory requirement of public interest can justify an importing Member State imposing its own rules on imported products. The principle of mutual recognition thus provided a major contribution to the single market, as it allowed for free movement of goods, whilst at the same time leaving each Member State free to apply its own regulations. Consequently, the burdensome road of positive integration (harmonisation of the different national rules by setting one standard for all Member States) is avoided, as market integration in many areas can be achieved through negative integration (mutual recognition). Only when a Member State succesfully invokes a 'mandatory requirement', will there be the need to remove such barriers through harmonisation.

Secondly, the *Dassonville*-interpretation brought about the need to clarify the exact scope of application of the former Article 28 EC. This was done in *Keck and Mithouard*[1127] by introducing a distinction within the group of measures applicable without distinction to domestic and imported products, between 'product requirements' (rules regulating the physical characteristics of a product) and provisions restricting or prohibiting certain 'selling arrangements' (rules regulating the way a product is sold). Only the first category of rules was held to be governed by Article 28, and consequently needs to be justified by the grounds provided for in the Treaty or the rule of reason. The second category is considered not to hinder trade (and, as a result, not to require justification), provided that these provisions apply to all relevant traders operating in the national territory, and so long as they affect in the same manner, in law and in fact, the marketing of domestic products and of those from other Member States[1128]. The idea behind this distinction is that rules governing the physical characteristics of a product are an obstacle to intra-EU trade as they require producers to modify their product in order to comply with the rules imposed by the country of destination. On the other hand, rules regulating the way a product is sold do not have any specific effect on intra-EU trade, unless they are (directly or indirectly) discriminatory[1129]. If such a

---

[1126] K. LENAERTS and P. VAN NUFFEL, *Constitutional law of the European Union*, London, Sweet & Maxwell, 1999, 138.

[1127] Joined cases C-267/91 and C-268/91, *Keck and Mithouard*, 24 november 1993, *ECR* 1993, 6097.

[1128] Joined cases C-267/91 and C-268/91, *Keck and Mithouard*, 24 november 1993, *ECR* 1993, 6097, § 16.

[1129] It should be noted that the opinions on the *Keck*-judgment were quite divided. In favour: e.g. N. BERNARD, "Discrimination and free movement in EC law", *I.C.L.Q.* 1996, vol. 45, 82 *et seq.*; N. BERNARD, "La libre circulation des marchandises, des personnes et des services dans le Traité CE sous l'angle de la compétence", *Cahiers de Droit Européen* 1998, 35; J. SNELL, *Goods and services in EC Law. A study of the relationship between the freedoms*, Oxford University Press, Oxford, 2002, 70 *et seq.* A more critical position is taken by e.g. L. GORMLEY, "Reasoning renounced? The remarkable judgment in Keck and Mithouard", *European Business* provision on selling arrangements has discriminatory effects, it may still be justified in accordance with the *Cassis de Dijon*-criteria in so far as it is applicable without distinction to domestic and national products[1130]. If the measure is directly discriminatory, it may only be justified on the grounds provided by the Treaty[1131].

V. Dassonville extended to other freedoms

The broad Dassonville-interpretation has gradually been extended to other Treaty freedoms. For a long time, it was assumed that the provisions on free movement of persons were not concerned with restrictions that applied without distinction between a State's own nationals and nationals of another Member State[1132]. However, the *Wolf* case of 1988 indicated that the Court would take a different approach. The Belgian measure at issue in *Wolf* treated Belgian nationals and nationals of other Member States equally, but nevertheless restricted the free movement of persons by treating *all* EU citizens less favourably when they had been employed in the territory of more than one Member State[1133]. The ECJ acknowledged that such a rule cannot be considered to discriminate on grounds of nationality, but the provisions on the free movement of persons are not confined to cases of (direct or indirect) nationality discrimination: these provisions are intended to *"facilitate the pursuit by Community citizens of occupational activities of all kinds throughout the Community, and preclude national legislation which might place Community citizens at a disadvantage when they wish to extend their activities beyond the territory of a single Member State."*

In the *Säger*-case of 1991, the ECJ made it clear that the freedom to provide services not only requires the elimination of all (direct or indirect) discrimination against a person providing services on the ground of his nationality, *"but also the abolition of any restriction, even if it applies without distinction to national providers of services and to those of other Member States, when it is liable to prohibit or otherwise impede the activities of a provider of services established in another Member State where he lawfully provides similar services."*[1134] Thus, the Court applied Dassonville to the freedom to provide services: not only discriminatory measures are to be abolished, restrictions which have the effect of making the provision of services between Member States more difficult than the provision of services within one Member State are targeted as well[1135].

Law Review 1994, 63-67; S. WEATHERILL, "After Keck: some thoughts on how to clarify the clarification", *Common Market Law Review* 1996, 33, 885-906, Opinion of Advocate-General Jacobs in C-412/93, *Société d'Importation Edouard Leclerc-Siplec v TF1 Publicité SA and M6 Publicité SA*, 9 February 1995, *ECR* 1995, 179, § 38 *et seq*. For a recent, critical analysis of the post-*Keck* case law, see D. WILSHER, "Does Keck-discrimination make any sense? An assessment of the non-discrimination principle within the European Single Market", *European Law Review* 2008, 33 (1), 3-22.

[1130] Joined cases C-34/95, C-35/95 and C-36/95, *De Agostini and TV-Shop*, 9 July 1997, *ECR* 1997, I-3843, § 44-45.

[1131] Eg. C-320/93, *Ortscheit GmbH v Eurim-Pharm Arzneimittel GmbH*, 10 November 1994, *ECR* 1994, I-5243.

[1132] An overview of the evolution of the case law in this regard is given in N. BERNARD, "Discrimination and free movement in EC Law", *ICLQ* 1996, 45 (1), 82-108; L. DANIELE, "Non-discriminatory restrictions to the free movement of persons", *E. L. Rev.* 1997, 22 (3), 191-200.

[1133] Joined cases C-154-155/87, *RSVZ v Wolf and others*, 7 July 1998, *ECR* 1998, 3897.

[1134] C-76/90, *Manfred Säger v Dennemeyer & Co. Ltd*, 25 July 1991, *ECR* 1991, I-4221, § 12. Similarly, C-55/94, *Gebhard*, 30 November 1995, *ECR* 1995, I-4165 for the freedom of establishment, and C-415/93, *Bosman*, 15 December 1995, *ECR* I-4921 for the free movement of workers.

[1135] Cf. C-381/93, *Commission v France*, 5 October 1994, *ECR* 1994, I-5145, § 16-17: *"under the Court' s consistent case-law Article [49] precludes the application of any national legislation which without objective justification impedes a provider of services from actually exercising that freedom. […] In the perspective of a single market and in order to permit the realization of its objectives, that freedom likewise precludes the*

The logical next step was taken in *Kraus*: the Court held that the free movement of workers and the freedom of establishment preclude national measures which, even though applicable without discrimination on grounds of nationality, are liable to hamper or to render less attractive the exercise by EU nationals of fundamental freedoms guaranteed by the Treaty[1136], thereby extending the *Dassonville*-interpretation to the free movement of persons.

This extension also entailed the possible application of the rule of reason-doctrine to case law on the free movement of persons. As a result, measures which may hinder or render less attractive the exercise of the free movement of persons may be compatible with the Treaty if four conditions are fulfilled:
1. The national measures must be applied in a non-discriminatory manner;
2. They must be justified by imperative requirements in the general interest;
3. They must be suitable for securing the attainment of the objective which they pursue; and
4. They must not go beyond what is necessary in order to attain it[1137].

The same is true for the freedom to provide services: the rule of reason applies here as well[1138]. It must be mentioned that the *Keck and Mithouard*-distinction does not apply in the context of the free movement of persons, nor does it apply to the freedom to provide services[1139].

VI. Conclusion

It follows from this brief summary that the general prohibition on nationality discrimination has been extended in two directions. First of all, not only direct discrimination by reason of nationality is forbidden, but also all indirect forms of discrimination which, by the application of other criteria of differentiation, lead in fact to the same result (e.g. *Sotgiu*). Secondly, not only rules which distinguish between national and cross-border situations are prohibited if they are not justified, but also provisions which hamper, directly or indirectly, actually or potentially, intra-EU trade (e.g. *Kraus*). However, an important proviso is to be made for the free movement of goods, where the discrimination-test still has considerable merit as a result of the *Keck*-distinction: selling arrangements are only contrary to the free movement provisions if they discriminate against products imported from other Member States. Moreover, with regard to the export of goods, the Court has decided in *Groenveld* that measures applicable without distinction to domestic and export trade fall outside the scope of the free movement provisions. Whether the ECJ's case law on direct taxation has evolved along the same lines will be discussed in the next chapter.

---

application of any national legislation which has the effect of making the provision of services between Member States more difficult than the provision of services purely within one Member State."

1136 C-19/92, *Dieter Kraus v Land Baden-Württemberg*, 31 March 1993, *ECR* 1993, I-1663, § 32

1137 C-55/94, *Gebhard*, 30 November 1995, *ECR* 1995, I-4165, § 37, which is phrased in a very broad manner, referring to all fundamental freedoms: *"It follows […] from the Court's case-law that national measures liable to hinder or make less attractive the exercise of fundamental freedoms guaranteed by the Treaty must fulfil four conditions: they must be applied in a non-discriminatory manner; they must be justified by imperative requirements in the general interest; they must be suitable for securing the attainment of the objective which they pursue; and they must not go beyond what is necessary in order to attain it."*

1138 E.g. C-205/84, *Commission v Germany*, 4 December 1986, *ECR* 1986, 3755, § 27; C-154/89, *Commission v France*, 26 February 1991, *ECR* 1991, I-659, § 14.

1139 E.g. C-384/93, *Alpine Investments*, 10 May 1995, *ECR* 1995, I-1141, § 33-39.

2. Non-discrimination in European tax law

A. Introduction

I. Purpose and scope of the study

A first encounter with the ECJ's body of case law in the area of direct taxation may cause a sense of bewilderment. Several judgments seem difficult to reconcile or even contradictory. However, a closer reading often reveals slight distinctions and subtle nuances. Apparent contradictions are frequently reconcilable on the basis of those distinctions and nuances. As Walt Whitman wrote in his seminal poem *Song of Myself*[1140]:

Do I contradict myself?
Very well, then, I contradict myself;
(I am large—I contain multitudes.)

Similarly, the ECJ's body of case law is large, and its apparent contradictions can often be explained by the multitudes contained in that case law. Among these multitudes are the different types of discrimination which have been distinguished in case law and legal writing, which make it difficult to accurately describe the notion 'discrimination' (see supra). Additionally, the apparent contradictions can sometimes be explained by a lack of analytical strictness in the Court's judgments (or in the academic discussion of those judgments). In particular, it seems that the ECJ sometimes takes arguments into consideration in the wrong step of its decision process. As a result, different judgments sometimes seem irreconcilable because identical arguments are taken into account in different steps of the decision process.

For that reason, I will try to keep a strict division between the different steps of the decision process when discussing the ECJ's case law. Ultimately, the purpose of this study is to verify whether there is a common idea of non-discrimination underlying the ECJ's case law in matters of direct taxation. In order to do so, I will discuss the case law from the perspective of, on the one hand, the comparability of the subject and object of comparion and, on the other hand, the treatment accorded to the subject of comparison[1141]. Both of those sections will be subdivided thematically into subsections.

In other words, the purpose of this study is not to expose contradictions in the case law or conflicts between the different decisions. Instead, I will try to find a common principle which underlies this case law and which may remove some apparent tensions. As will become apparent throughout the discussion of the Court's decisions, that common principle is the principle of non-discrimination.

[1140] W. WHITMAN, *Leaves of Grass*, 1855.
[1141] Given the scope of this study, I will mainly address the **existence** of a discrimination, rather than the possible justification thereof. Accordingly, the focus will be on the first two steps of the analysis (i.e. the comparability-test and the disadvantage-test). The third step (the justification-test) will only be discussed insofar it has a bearing on the first two steps. For a recent overview of the justification-issue in the area of direct taxation, see A. CORDEWENER, G. KOFLER and S. VAN THIEL, "The clash between European freedoms and national direct tax law: public interest defences available to the Member States", *Common Market Law Review* 2009, 1951-2000.

II. The case law of the European Court of Justice on direct taxation

The ECJ's body of case law on direct taxation is steadily expanding[1142]. Yet, when discussing this case law, it should be borne in mind that it is part of a much larger body of case law on non-discrimination and the fundamental freedoms that has evolved over the past decades. Direct taxation is, in principle, a matter of the Member States' national sovereignty, but this sovereignty is limited by aspects of EU law, of which the free movement rules and the rules on State aid are the most important ones. Consequently, even though Member States are in principle free to design their tax system, they must not violate the relevant provisions of EU law[1143]. This study is only concerned with the compatibility of Member States' tax systems with the free movement provisions.

Unlike the U.S. Supreme Court's constitutional jurisprudence (see infra, 3), the ECJ's analysis in direct tax cases does not differ from other areas of the law[1144]. A tax disadvantage is just another obstacle to individuals and companies wishing to exercise their Treaty freedoms[1145]. As a result, the general remarks made above with regard to the ECJ case law on discrimination apply to the case law on direct taxation, notwithstanding several specific refinements[1146]. These refinements will become apparent throughout the discussion of the relevant case law, but it may be advisable to point out some important differences.

First of all, given the specific relationship between a person's nationality and his taxability, the case law has deviated somewhat from the general approach with regard to discrimination. For instance, in *Gilly*, the ECJ has held that a Member State did not discriminate directly on grounds of nationality merely because it explicitly based its taxing rights on an individual's nationality. As will be explained in detail below, this position should be seen in the context of the distinction between the allocation of taxing powers, and the exercise of these powers: the Member States are free to determine the criteria and connecting factors with respect to direct taxation, but they may not disregard EU law as far as the *exercise* of the power of taxation so allocated is concerned (cf. infra).

Secondly, in its tax case law on corporate establishment, the ECJ tends to replace references to 'indirect discrimination' with 'unequal treatment' (or 'inequality of treatment'). In its earlier case law, the ECJ used the traditional notion of indirect discrimination (cf. supra) to analyse rules based on a company's seat or residence[1147]. In more recent cases, however, the

---

[1142] This study is mainly concerned with direct taxation. Case law dealing with other taxes will be addressed insofar as it is relevant for the evolution of the case law on direct taxation.

[1143] The ECJ's standard formula in this regard is that *"although direct taxation falls within their competence, the Member States must none the less exercise that competence consistently with Community law"*, see e.g. C-80/94, *Wielockx*, 11 August 1995, *ECR* 1995, I-2493, § 16; C-311/97, *Royal Bank of Scotland*, 29 April 1999, *ECR* 1999, I-02651, §19.

[1144] E.g. Case 82/71, *Italy v Società agricola industria latte (SAIL)*, 21 March 1972, § 5: *"the effectiveness of Community law cannot vary according to the various branches of national law which it may affect."* See also P. STANLEY, "Review Essay: Case C-107/94, Asscher v. Staatssecretaris van Financiën", *Common Market Law Review* 1997, 713: *"The field of direct taxation is one area where Member States are inclined to be especially protective of their rights. Nevertheless, the Court of Justice has declined to erect a barrier around tax law, and vigorously maintains its insistence that here, as elsewhere, Member States must exercise their powers consistently with the fundamental principles of Community law."*

[1145] R. LYAL, "Non-discrimination and direct tax in Community law", *EC Tax Review* 2003, 68

[1146] The most important of these refinements is that the ECJ has tried to transpose its restriction-based reading to direct tax cases, but that this attempt has not been entirely succesful: see infra.

[1147] E.g. C-330/91, *Commerzbank AG*, 13 July 1993, *ECR* 1993, I-4017.

Court substituted this notion with 'unequal treatment'[1148]. As a result, the Court side-steps the difficulty that rules which are based on a company's seat or residence, technically may amount to direct discrimination on the grounds of nationality, and can therefore only be justified by relying on the grounds provided by the Treaty[1149].

Finally, even though the ECJ has tried to apply the principles developed in its non-tax case law to direct tax cases, this has often proven to be difficult – if not impossible. The most telling example is the evolution in the Court's general tax law from a pure discrimination-based analysis towards a broader, restriction-based reading of the Treaty freedoms. As will become apparent in 2.D.V, the Court has tried to transpose this evolution to the field of direct taxation, but this has not been a resounding success.

Even though there are some deviations, the general approach in tax cases and in non-tax cases is the same. As a result, the standard Aristotelian formula applies in tax matters as well: *"comparable situations must not be treated differently and different situations must not be treated in the same way unless such treatment is objectively justified"*[1150]. This chapter will be structured along the lines of the different elements of this formula. After a brief general overview of the Court's position on these matters, I will examine the case law against the backdrop of the two constitutive elements of discrimination: comparability and difference in treatment. The third element in the ECJ's discrimination-analysis, the justification-test, will only be addressed insofar as it is relevant to the actual inquiry as to whether discrimination has occurred (i.e. the first two steps).

> The general starting point will be that the fundamental freedoms are all based on a common, underlying principle of non-discrimination[1151]. The purpose of this part of the study is to identify this principle and to compare it to the standard underlying Art. 24 OECD MC, identified in Part II. Consequently, I start from the assumption that the comparability-test and the disadvantage-test are identical in all four fundamental freedoms[1152].
>
> In this respect, reference should be made to the Court's case law on the free movement of capital in relation to third countries. In that context, the Court has repeatedly held that *"because of the degree of legal integration that exists between*

[1148] E.g. C-264/96, *ICI v Colmer*, 16 July 1998, *ECR* 1998 I-4695; C-307/97, *Saint-Gobain*, 21 September 1999, *ECR* 1999, I-6161; C-141/99, *Algemene Maatschappij voor Investering en Dienstverlening NV (AMID) v Belgische Staat*, 14 December 2000, *ECR* 2000, I-11619.

[1149] P. FARMER, "The Court's case law on taxation: a castle built on shifting sands?", *EC Tax Review* 2003, 76

[1150] E.g. C-279/93, *Schumacker*, 14 February 1995, *ECR* 1995, I-225, § 30; C-80/94, *Wielockx*, 11 August 1995, *ECR* 1995, I-2493, § 17; C-107/94, *Asscher*, 27 June 1996, *ECR* 1996, I-3089, § 40; C-311/97, *Royal Bank of Scotland*, 29 April 1999, *ECR* 1999, I-02651, § 26.

[1151] See also R. LYAL, "EU Report", in IFA, *Cahiers de droit fiscal international. Non-discrimination at the crossroads of international taxation*, Vol. 93a, Amersfoort, Sdu Fiscale & Financiële Uitgevers, 2008, 64.

[1152] According to Article 65 TFEU *"the provisions of Article 63 shall be without prejudice to the right of Member States to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested."* However, such tax rules *"shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 63."* When this provision was introduced, some authors suggested that it would lead to a severe restriction of the free movement of capital (e.g. B. KNOBBE-KEUK, "The Ruding Committee Report – An impressive vision of European company taxation for the year 2000", *EC Tax Review* 1992, 1, 30 and B. GOUTHIERE, "Removal of discrimination – A never-ending story", *European Taxation* 1994, 302). However, it is now generally accepted that Article 65 TFEU merely expresses the Court's practice as developed in the context of the other freedoms (e.g. F. VANISTENDAEL, "The limits to the new Community tax order", *C.M.L.R.* 1994, 314; J. ENGLISCH, "The European Treaties' implications for direct taxes", *Intertax* 2005, 326 and C-35/98, *Verkooijen*, 6 June 2000, § 43).

Member States of the Union, in particular by reason of the presence of Community legislation which seeks to ensure cooperation between national tax authorities, […] the taxation by a Member State of economic activities having cross-border aspects which take place within the Community is not always comparable to that of economic activities involving relations between Member States and non-member countries"[1153]. At first glance, this seems to indicate that the comparability-test is affected by the fact that a third country is involved. More specifically, this statement might suggest that the object of comparison is an intra-EU transaction while the subject of comparison is a transaction involving a third country. Given the degree of legal integration in the EU, object and subject of comparison are, in principle, not comparable. However, this interpretation is not entirely convincing, as the ECJ has traditionally held that matters relating to the cooperation between national tax authorities are not a matter of comparability, but of justification[1154].

A more convincing interpretation of this statement is that **justification grounds** may differ between intra-EU transactions and transactions involving a third country. In other words, the statement that the situations are *"not always comparable"* does not refer to the comparison between object and subject of comparison as the first step of the discrimination-analysis, but to the comparison between two bodies of case law. The ECJ has developed a body of case law as regards justification grounds that are accepted in intra-EU situations, and this case law applies irrespective of which freedom is at play. However, this case law cannot simply be transposed to situations where a third country is involved (a situation which, by definition, can only fall within the scope of the free movement of capital). Because of the degree of legal integration in the EU, it is possible that a justification ground is accepted in a situation involving a third country, even though that justification has been dismissed in an intra-EU situation[1155]. From that perspective, the two bodies of case law are *"not always comparable"*. However, that does not mean that the discrimination-test as such, i.e. comparability and disadvantage, is different in a situation involving a third country. This point will be further addressed in 2.E.I.A.b.8.b.

B. Comparable situations

As was the case under Article 24 OECD MC, the comparability-analysis is decisive in many cases decided by the ECJ under the fundamental freedoms. Here as well, the determination of the relevant characteristics is of the utmost importance. That issue will be addressed in 2.E.I.A, where the ECJ's relevant case law will be discussed.

The main issue at stake throughout this case law is the distinction between residents and non-residents of a Member State, a distinction which is vital in international taxation. As a general rule, the ECJ seems to start from the assumption that residents and non-residents are not comparable, unless there are valid reasons for deciding otherwise. In contrast, where the comparison is between two residents, the ECJ starts from the assumption that they are comparable, and then determines whether there are valid reasons for incomparability.

[1153] E.g. C-446/04, 12 December 2006, *Test Claimants in the FII Group Litigation*, § 170; C-101/05, 18 December 2007, *Skatteverket v A*, § 37; C-201/05, 23 April 2008, *Test Claimants in the CFC and Dividend Group Litigation*, § 92.
[1154] E.g. C-520/04, 9 November 2006, *Turpeinen*, § 35.
[1155] E.g. C-446/04, 12 December 2006, *Test Claimants in the FII Group Litigation*, § 171; C-101/05, 18 December 2007, *Skatteverket v A*, § 37; C-201/05, 23 April 2008, *Test Claimants in the CFC and Dividend Group Litigation*, § 93.

The reasons underlying those assumptions and the grounds accepted by the ECJ in order to discard the assumptions will be analysed by discussing the relevant case law, which will be divided thematically for this purpose.

C. Equal treatment

If two situations are comparable, the principle of non-discrimination demands that they be treated equally. The intricacies of this requirement will be addressed by analyzing the relevant ECJ case law in 2.E.I.B. However, some general remarks on the Court's interpretation of the equal treatment-requirement can be made here.

First of all, the term 'equal treatment' may be somewhat misleading, as it actually concerns a protection from discrimination, i.e. the protected person or situation (the subject of comparison) must not be treated less favourably than the object of comparison. Thus, the test is actually not as strict as requiring 'equal' treatment. Rather, it is sufficient that the subject of comparison is not treated less favourably (which is why I will refer to this test as the 'disadvantage-test'). In case the subject of comparison is treated more favourably than the object of comparison, there is no immediate issue of discrimination. Issues of reverse discrimination, which may arise in such a case, are addressed elsewhere.

Furthermore, there is no 'de minimis'-exception in the context of the disadvantage-test. In other words, as soon as the subject of comparison is treated less favourably, the equal treatment-requirement has been violated, regardless of the severity of the disadvantage: it is settled case law that any disadvantage, even minor, can violate the equal treatment-test[1156].

Finally, the Court is reluctant to take account of offsetting advantages which might remove the disadvantage at issue. Particularly, it seems that the Court generally refuses to accept that a disadvantage may be neutralised by advantages granted in the Member State in question[1157] or in another Member State[1158].

[1156] E.g. C-270/83, *Avoir fiscal*, § 21: "*it is also not necessary in this context to assess the extent of the disadvantages which branches and agencies of foreign insurance companies suffer as a result of the failure to grant them the benefit of shareholders' tax credits and to consider whether those disadvantages could have any effect on their tariffs, since Article 52 prohibits all discrimination, even if only of a limited nature.*" Cf. also C-49/89, *Corsica Ferries France*, § 8; C-169/98, *Commission v France*, § 46 and C-212/06, *Government of the French Community and Walloon Government v Flemish Government*, § 52

[1157] E.g. C-270/83, *Avoir fiscal*, § 21: *"the difference in treatment also cannot be justified by any advantages which branches and agencies may enjoy vis-à-vis companies and which […] balance out the disadvantages resulting from the failure to grant the benefit of shareholders' tax credits. Even if such advantages actually exist, they cannot justify a breach of the obligation laid down in Article 52 to accord foreign companies the same treatment in regard to shareholders' tax credits as is accorded to French companies"*; C-307/97, *Saint-Gobain*, § 53: *"it must be observed that the difference in tax treatment between resident companies and branches cannot […] be justified by other advantages which branches enjoy in comparison with resident companies and which, according to the German Government, will compensate for the disadvantages of not being allowed the tax concessions in question. Even if such advantages exist, they cannot justify breach of the obligation laid down in Article 52 of the Treaty to accord the same domestic treatment concerning the tax concessions in question."*

[1158] E.g. C-294/97, *Eurowings*, § 44: *"Any tax advantage resulting for providers of services from the low taxation to which they are subject in the Member State in which they are established cannot be used by another Member State to justify less favourable treatment in tax matters given to recipients of services established in the latter State."*

D. Types of discrimination

I. Direct – indirect discrimination

As indicated above, not only rules which differentiate on the basis of nationality amount to discrimination: rules which apply other differentiating criteria, but in fact lead to the same result as a directly discriminatory rule are forbidden as well. The same is true in matters of direct taxation, where distinctions are rarely made on the basis of nationality but often on the basis of residence. I have already indicated above that the situations of residents and non-residents are, normally, not comparable. However, it is possible that no relevant difference exists between both categories. In such a case, different treatment might amount to discrimination (cf. supra). Furthermore, it is clear that a tax rule which differentiates on the basis of residence amounts to indirect discrimination, insofar as the rule mainly burdens nationals of other Member States. It is clear, indeed, that a rule targeting non-residents will often fall heavier on foreign nationals.

For that reason, the Court has confirmed the *Sotgiu* reasoning in direct tax cases as well, starting with the *Biehl* case[1159]. In *Biehl*, the Court started by repeating the *Sotgiu* formula: "*the rules regarding equality of treatment forbid not only overt discrimination by reason of nationality but also all covert forms of discrimination which, by the application of other criteria of differentiation, lead to the same result.*"[1160] The Court applied this principle to the residence criterion of the national legislation at issue, and concluded: "*even though the criterion of permanent residence in the national territory […] applies irrespective of the nationality of the taxpayer concerned, there is a risk that it will work in particular against taxpayers who are nationals of other Member States.*"[1161]

The same is true for companies. The Court has held in *Avoir fiscal* that, with regard to companies, "*it is their registered office […] that serves as the connecting factor with the legal system of a particular state, like nationality in the case of natural persons.*"[1162] Indirect discrimination may arise if a tax rule differentiates on the basis of other criteria than the seat of the company. For instance, in *Commerzbank*, the ECJ held that "*the rules regarding equality of treatment forbid not only overt discrimination by reason of nationality or, in the case of a company, its seat, but all covert forms of discrimination which, by the application of other criteria of differentiation, lead in fact to the same result.*"[1163]

Applied to the distinguishing criterion at issue in *Commerzbank* (i.e. fiscal residence): "*Although it applies independently of a company's seat, the use of the criterion of fiscal residence within national territory for the purpose of granting repayment supplement on overpaid tax is liable to work more particularly to the disadvantage of companies having*

[1159] C-175/88, *Biehl*, 8 May 1990, *ECR* 1990, I-1779.
[1160] C-175/88, *Biehl*, § 13.
[1161] C-175/88, *Biehl*, § 14.
[1162] Case 270/83, *Avoir fiscal*, § 18. The Court refers to the 'registered office' as the relevant criterion, but it seems unlikely that it wanted to exclude the two other criteria of Article 54 TFEU. Instead, it seeems that the reference to the 'registered office' is really a mistranslation, since the other language versions of *Avoir fiscal* all refer to the 'corporate seat' ('siège' in French, 'Sitz' in German, 'zetel' in Dutch), i.e. the generic term to refer to all three criteria of Article 54 TFEU. See also J. WOUTERS and P. DE MAN, "EC law and residence of companies", in G. MAISTO (ed.), *Residence of companies under tax treaties and EC law*, IBFD, Amsterdam, 2009, 73-74.
[1163] C-330/91, *Commerzbank*, § 14.

their seat in other Member States. Indeed, it is most often those companies which are resident for tax purposes outside the territory of the Member State in question.”[1164]

II. Reverse discrimination

With regard to the issue of reverse discrimination, I refer to what has been said above: EU law is not concerned with purely internal situations. As a result, the fundamental freedoms cannot be invoked in such a situation. However, in cases where nationals of a Member State are, by reason of their conduct, in a situation which may be regarded as equivalent to that of any other person enjoying the rights and liberties guaranteed by the Treaty, the Treaty freedoms apply to such nationals as well. This conclusion is also upheld in tax cases[1165].

V. Is the ECJ’s case law in direct tax matters still based on a discrimination-analysis, or has it evolved towards a restriction-based reading of the Treaty?

V.A. Restrictions: a similar evolution in direct tax case law?

I have already referred to the broad interpretation in *Dassonville* of ‘measures having effect equivalent to quantitative restrictions on imports’. Such measures were defined as *“all trading rules enacted by Member Sates which are capable of hindering, directly or indirectly, actually or potentially, intra-community trade.”* As a result, measures applicable without distinction to domestic and imported products were targeted as well. Thus, the test is no longer whether the national measure distinguishes between domestic and imported products, but whether the measure (directly or indirectly, actually or potentially) is capable of hindering the free movement of goods. There has been some controversy surrounding the question whether this approach (and the rule of reason-doctrine of *Cassis de Dijon*) can also be upheld in direct tax matters.

At first glance, it seems that the ECJ has adopted the restriction-approach in its direct tax case law as well. Starting with *Futura*, in 1997, the Court has struck down more and more national measures that were *“liable to hinder or dissuade the exercise of the Treaty freedoms”*, without referring to any distinction on the basis of nationality. *Futura* is therefore generally considered as the first of the so-called ‘second generation’ cases in the ECJ’s body of direct tax case law (see infra, 2.D.V.B)[1166].

[1164] C-330/91, *Commerzbank*, § 15.
[1165] E.g. C-107/94, *Asscher*, § 32. As an example of reverse discrimination in the area of direct taxation, reference can be made to expatriate regimes, which grant tax benefits exclusively to, for instance, foreign managers (see also Part II, 2.B.VI.B).
[1166] There are also earlier indications that the Court might try to apply a restriction-based reading of the Treaty freedoms. A very early example in the specific context of the free movement of goods is Case 18/84, *Commission v France*, 7 May 1985. In that case, the Court was called to decide on a provision in the French tax code which granted certain tax advantages to newspaper publishers with regard to publications printed in France. These advantages were not accorded in case the publications were printed abroad. Such a rule, which is applicable without distinction between French and foreign publishers, may hamper intra-EU trade, by encouraging French publishers to conclude contracts with French printers and not with printers established in other Member States. The Court decided that the French provision amounted to a measure having an effect equivalent to a quantitative restriction on imports, as it was likely to restrict imports of publications printed in other Member States. As a result, Article 34 TFEU had been violated. It should be noted that the Court set aside

Before analysing the ECJ's relevant case law, there are two important remarks to be made. First, the question arises whether the *Bosman*-reasoning can be transposed to direct tax matters[1167]. What is at stake here is the way in which the Court assesses whether a national measure is restrictive. At first sight, it would seem that measures without distinction which hinder the exercise of the Treaty Freedoms must cause a disadvantage **as compared to a comparable internal situation**. In other words, one might think that the ECJ would restrict itself to striking down non-discriminatory restrictions which dissuade cross-border activities as compared to domestic activities. However, *Bosman* seems to indicate that measures having exacy the same effect on domestic situations as on cross-border situations may be struck down as well, if those measures make it virtually impossible to go abroad. The measure at issue in *Bosman* restricted domestic situations in exactly the same manner as cross-border situations[1168]. However, given the restrictive effect of this measure on cross-border activity, the ECJ considered it to be incompatible with the freedom of movement. Transposed to direct taxation, this would imply that tax measures which restrict cross-border traffic in a non-discriminatory way (e.g. thin cap-rules, CFC-rules, etc.) cannot always be made EU-proof by merely making them applicable to domestic situations as well. Even rules that are completely neutral may be incompatible with the fundamental freedoms if they make it impossible to go to another Member State, regardless of whether the same restriction would exist in a domestic situation[1169]. However, the overview of the 'restriction'-based case law (see infra, 2.D.V.B) suggests that the Court has refrained from applying a *Bosman*-type reasoning in substantive direct tax matters. Instead, the Court generally assesses whether the measure is 'restrictive' by comparing the cross-border situation to a purely domestic situation. The situation seems to be different in the context of procedural tax law: the measure at issue in *Futura* was completely neutral (i.e. applied regardless of the existence of a cross-border element), but was nevertheless held to be restrictive.

Secondly, it is important to note that the distinctions drawn above are merely tools to structure and classify the Court's vast body of case law. However, the ECJ does not adhere to these distinctions dogmatically, and its case law is subject to constant evolutions. Therefore, it is sometimes difficult to reconcile broad statements made in early cases with evolutions in later case law. A clear example of this is the statement in *Gebhard* that the rule of reason-defense could only be invoked if the national measure at issue applied without distinction on the basis of nationality. Similar statements have been made in the area of direct taxation[1170]. However, it seems that the Court has abandoned this strict dichotomy, by applying the rule of reason-

---

the French government's argument that printing is a service and cannot be regarded as a product: *"printing work cannot be described as a service, since it leads directly to the manufacture of a physical article which, as such, is classified in the common customs tariff […]. In any event, Article 60 of the Treaty provides that services shall be considered to be 'services' within the meaning of this Treaty where they are normally provided for remuneration, in so far as they are not governed by the provisions relating to freedom of movement for goods, capital and persons. The case must therefore be considered solely on the basis of Article 30."* However, given the surge in 'restriction'-cases in the years following *Futura*, the latter case will be used as the starting point for this 'second generation' of case law.

[1167] C-415/93, *Bosman*, 15 December 1995.

[1168] C-415/93, *Bosman*, § 98-99: *"It is true that the transfer rules in issue in the main proceedings apply also to transfers of players between clubs belonging to different national associations within the same Member State and that similar rules govern transfers between clubs belonging to the same national association. […] However, […] those rules are likely to restrict the freedom of movement of players who wish to pursue their activity in another Member State by preventing or deterring them from leaving the clubs to which they belong even after the expiry of their contracts of employment with those clubs."*

[1169] J. TERRA and P. WATTEL, *European Tax Law*, Deventer, Kluwer, 2005, 56-57.

[1170] E.g. C-270/83, *Avoir fiscal*, § 25.

test in clear discrimination-cases. For instance, in *Lindman*, the ECJ noted that the Finnish measure at issue was 'manifestly discriminatory'[1171]. The Finnish government tried to justify the measure by relying on reasons in the public interest. Even though the measure was discriminatory, the Court did not dismiss the Finnish government's argument on the basis that only measures that apply without distinction can be justified on the basis of the rule of reason-defense. Instead, the Court noted that the Finnish government did not demonstrate that the measure was appropriate and proportional[1172]. Similarly, in *Wallentin*, the Court did not dismiss the fiscal cohesion-justification on the ground that discriminatory measures were not justifiable on a rule of reason-basis. Instead, the ECJ dismissed the cohesion-argument on substantive grounds[1173]. A similar evolution has taken place in non-tax cases[1174].

For the time being, I will accept this evolution as a given, without questioning its theoretical appropriateness. Accordingly, throughout the discussion of the case law in the remainder of this chapter, I will not distinguish between cases on this basis. Instead, I will assume that the rule of reason-analysis can also be applied to discriminatory measures[1175].

One may wonder, finally, whether the distinction between discrimination and restriction is still valid. On the one hand, the distinction between restriction and indirect discrimination is quite vague, in that they both concern measures that, on the face of things, do not distinguish between on the basis of the prohibited criterion, but rather disadvantage the cross-border situation or impede the crossing of borders. On the other hand, the distinction between both concepts at the justification-level has apparently been abandoned by the Court, as both discriminatory and restrictive measures may be saved by the rule of reason. In this regard, Advocate-General Geelhoed has suggested that, *"in the direct taxation sphere, there is no practical difference between these two manners of formulation, i.e. 'restriction' and 'discrimination'"*[1176]. I will address the relationship between both concepts in the next chapter, which consists of three parts. First, I will give an overview of the Court's relevant case law. In this respect, it will be helpful to draw a distinction betwee three 'generations' of direct tax cases. Next, I will argue that the restriction-based analysis in many cases is actually a reformulation of the discrimination-based analysis. Even though the Court uses language that refers to 'restrictions', the actual analysis in these cases is based on the concept of discrimination. The final part is based on the idea that the existence of actual restriction-based cases does not mean that the discrimination-standard is redundant. Both concepts are complementary components of the fundamental freedoms.

[1171] C-42/02, *Lindman*, 13 November 2003, § 22.

[1172] C-42/02, *Lindman*, § 25-26.

[1173] C-169/03, *Wallentin*, 1 July 2004, § 21-22. See also the Opinion of Advocate-General Maduro in C-446/03, *Marks & Spencer*, § 33: *"Advocate General Léger has already had occasion to recall that, in the area of tax, the Court accepts that "discriminatory national rules may be justified for imperative public-interest requirements other than those set out in the Treaty and in particular in the name of the cohesion of the tax system." However, those judgments contradict a more general approach taken by the Court which applies also in tax matters whereby it affirms that a discriminatory measure can be justified only on the basis of derogating provisions expressly provided for in the Treaty. It would be useful for the Court to put an end to these uncertainties."*

[1174] E.g. C-240/95, *Schmit*, 27 June 1996 and C-120/95, *Decker*, 28 April 1998. See also M. FALLON and D. MARTIN, "Dessine-moi une discrimination", *Journal de Droit Européen* 2000, 166-167.

[1175] See also G. DAVIES, *Nationality discrimination and free movement law*, Proefschrift Rijksuniversiteit Groningen, 2002, 37-39.

[1176] Opinion of Advocate-General Geelhoed in C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue*, 23 February 2006, *ECR* 2006, I-11673, § 36.

V.B. From discrimination to restriction and back

a. Introduction: three generations of cases

The brief overview given above suggests that the ECJ's case law in direct taxes has evolved along the same path as its Treaty freedom case law in other areas: the general prohibition on nationality discrimination has been extended in two directions. First of all, not only direct discrimination by reason of nationality is forbidden, but also all indirect forms of discrimination. Secondly, it seems that the ECJ has gradually evolved from a discrimination-based reading of the Treaty freedoms to a restriction-based reading. However, this extension does not imply that the Treaty freedoms are no longer considered to be founded on the non-discrimination principle.

In legal writing, two generations of ECJ direct tax cases have been identified[1177]. The first wave of cases, starting in 1986 with *Avoir Fiscal*, strictly applied the discrimination-analysis. Examples of this line of case law include *Schumacker*, *Wielockx*, *Royal Bank of Scotland*, etc. In a second generation, starting in 1997 (*Futura*, later confirmed in *ICI*, *Baars*, *Saint-Gobain*, *Safir*, *Verkooijen*, etc.), the Court has apparently moved towards a restriction-analysis. Under that analysis, the Court adopts the language first used in non-tax cases such as *Gebhard* and *Bosman* and verifies whether the national measure at issue *"is liable to hinder or make less attractive"* the exercise of the Treaty freedoms. However, it seems that the second generation has come to an end and that the ECJ has shifted away from a simple restriction-based reading to a more nuanced discrimination-based approach (see infra).

The obvious problem with a pure restriction-based reading of the Treaty freedoms is that it is difficult to reconcile with the Member States' sovereignty in direct tax matters. Member States remain free to choose their tax rate, tax base, to what extent they wish to relieve double taxation, etc. As a result of this sovereignty, the different tax systems of the Member States exist side by side. This coexistence of discrete systems is obviously *"liable to hinder or make less attractive"* the exercise of the Treaty freedoms. For instance, a higher tax rate in Member State A as compared to Member State B can be seen as liable to hinder State B taxpayers from moving to State A. Moreover, Member States are free to assert their taxing jurisdiction on the basis of residence (worldwide taxation) and on the basis of source (limited, territorial taxation). Consequently, cross-border income streams are liable to be taxed twice. Leaving aside the possible impact of tax treaties, there is no obligation for the States involved to remove this double taxation. EU law does not require the home State to grant a relief for tax incurred in the source State[1178]. Once again, these fundamental aspects of tax sovereignty inevitably lead to 'restrictions' on the exercise of the Treaty freedoms[1179].

It was therefore unavoidable that the strict restriction-based reading would prove to be unsuited for direct tax issues and that the Court would run into the boundaries of this

[1177] E.g. L. HINNEKENS, "The search for the framework conditions of the fundamental EC Treaty principles as applied by the European Court to Member States' direct taxation", *EC Tax Review* 2002, 113 *et seq.*; A. ZALASINSKI, "The limits of the EC concept of 'direct tax restriction on free movement rights', the principle of equality and ability to pay, and the interstate fiscal equity", *Intertax* 2009, 283 *et seq.* Obviously, these 'generations' overlap to some degree. For instance, *Royal Bank of Scotland*, a clear example of a discrimination-based approach, was decided in 1999, after the start of the second generation.
[1178] See infra, the discussion of *Kerckhaert-Morres*.
[1179] See also P. FARMER and R. LYAL, *EC Tax Law*, Oxford, Clarendon Press, 1994, 328: *"Taken to its logical conclusion, an approach focusing on the exercise of a restriction rather than on discrimination would bring all charging provisions in national tax legislation within the scope of the Treaty Articles on the freedoms."*

interpretation. Essentially, the Court had two options for dealing with this issue. First, it could consider these impediments resulting from the Member States' fiscal sovereignty to be restrictive (in the first step of its analysis) but justified (in the second step). A second option would be to narrow down the concept of 'restriction' in direct tax cases. In fact, the Court has applied both these options in its case law of the last decade, but ultimately, starting with *D* in 2005, it has shown a preference for the second option.

b. The second generation: a restriction-based reading of the Treaty freedoms

In the late 1990's, the Court took a cue from its case law in non-tax matters and started to apply a restriction-based interpretation of the Treaty, at least on the level of language. Under that approach, the ECJ first verifies whether the national measure at issue "is liable to hinder or make less attractive" the exercise of the Treaty freedoms. In a second step, the Court analyses whether the measure can be justified. Consequently, instead of the traditional three-step test of the discrimination analysis, there are only two steps under this restriction-based approach.

The most obvious difference between the discrimination-test and the restriction-test is the absence of a comparability-analysis in the latter. In that sense, restriction could be considered as being an absolute concept that operates independently, meaning that it is independent from the treatment of other situations[1180]. The cross-border situation is assessed in isolation, without taking account of comparable domestic situations. It has been argued that in order to achieve an internal market, it is necessary to extend the scope of the fundamental freedoms beyond a mere guarantee of equal treatment, since non-discrimination is insufficient to remove all obstacles to the free movement[1181]. However, as will become apparent below, the main strength of the restriction-based reading – i.e. that it operates as an absolute concept, without requiring an object of comparison – has also proven to be its weakness, given the particular nature of direct taxation.

In my view, the second generation of cases spans from May 1997 (*Futura*) to March 2005 (*Laboratoires Fournier*)[1182]. In this period, the ECJ decided 39 direct tax cases on the basis of the free movement provisions[1183].

[1180] A. CORDEWENER, "The prohibitions of discrimination and restriction within the framework of the fully integrated internal market", in F. VANISTENDAEL (ed.), *EU Freedoms and direct taxation*, Amsterdam, IBFD Publications, 2006, 26.

[1181] E.g. M. BOUTARD LABARDE, "Case note: C-300/90, *Commission v Belgium* and C-204/90, *Bachmann*", *JDI (Clunet)* 1992, 2, 447; E. STEINDORFF, *EG-Vertrag und Privatrecht*, Baden-Baden, Nomos Verlagsgesellschaft, 1996, 65; L. HINNEKENS, "The search of the framework conditions of the fundamental EC Treaty principles as applied by the European Court to Member States' direct taxation", *EC Tax Review* 2002, 119 (referring to R. BARENTS).

[1182] Any attempt to reduce a living and evolving system such as the ECJ's body of case law to structured categories is artificial, and approximate at best. Nevertheless, the use of these 'generations' helps to understand the evolution the case law has gone through. The second generation of case-law stops with *Laboratoire Fournier* because it was followed by *D*, which paved the way for the third generation.

[1183] C-250/95, *Futura*, 15 May 1997; C-118/96, *Safir*, 28 March 1998; C-336/96, *Gilly*, 12 May 1998; C-264/96, *ICI*, 16 July 1998; C-311/97, *Royal Bank of Scotland*, 29 April 1999; C-254/97, *Baxter*, 8 July 1999; C-391/97, *Gschwind*, 14 September 1999; C-307/97, *Saint-Gobain*, 21 September 1999; C-439/97, *Sandoz*, 14 October 1999; C-294/97, *Eurowings*, 26 October 1999; C-55/98, *Vestergaard*, 28 October 1999; C-200/98, *X AB & Y AB*, 18 November 1999; C-251/98, *Baars*, 13 April 2000; C-87/99, *Zurstrassen*, 16 May 2000; C-35/98, *Verkooijen*, 6 June 2000; C-156/98, *Germany v Commission (tax incentives new Länder)*, 19 September 2000; C-141/99, *AMID*, 14 December 2000; Joined Cases C-397/98 and C-410/98, *Metallgesellschaft and Hoechst*, 8 March 2001; C-17/00, *De Coster*, 29 November 2001; C-431/01, *Mertens*, 12 September 2002; C-136/00, *Danner*, 3 October 2002; C-436/00, *X & Y*, 21 November 2002; C-324/00, *Lankhorst-Hohorst*, 12 December 2002; C-

The starting-point is *Futura*, or at least the part of that decision that dealt with the accounting obligation imposed on non-resident taxpayers[1184]. The Luxembourg measure at issue in *Futura* concerned non-resident taxpayers with a permanent establishment in Luxembourg. In order to carry forward losses suffered by the Luxembourg PE, these taxpayers were required to keep 'proper accounts' in Luxembourg, i.e. accounts that complied with the relevant Luxembourg accounting rules. Luxembourg residents wishing to carry forward losses were also required to keep proper accounts during the financial year in which the losses were incurred. The measure at issue was therefore applicable without distinction, but it was nevertheless liable to hinder cross-border activities since the non-resident taxpayer was already required to keep accounts in his home State. The Luxembourg obligation to keep separate accounts for the PE resulted in a double burden for non-residents exercising their activities in Luxembourg through a PE[1185]. The ECJ decided that this restriction was in principle prohibited, but that it could be justified on the basis of reasons of public interest.

Thus, *Futura* was the first (and, possibly, the last; see infra) direct tax case in which an actual restriction-approach was followed. Even though the measure applied without any distinction, the Court considered that the resulting obstacle was in principle contrary to EU law. This approach was also reflected in the language used by the Court (*"Such a condition may constitute* ***a restriction*** *[…] on the freedom of establishment"* and *"the effectiveness of fiscal supervision constitutes an overriding requirement of general interest capable of justifying* ***a restriction*** *on the exercise of fundamental freedoms"*[1186]). Subsequent judgments also used language referring to 'restrictions'. Of the 39 judgments decided during this period, 20 used language referring to a restriction-based reading of the Treaty[1187]. However, as will become apparent in 2.D.V.C, many of these cases were, in substance, discrimination-cases.

385/00, *De Groot*, 12 December 2002; C-234/01, *Gerritse*, 12 June 2003; C-422/01, *Skandia*, 26 June 2003; C-168/01, *Bosal*, 18 September 2003; C-209/01, *Schilling*, 13 November 2003; C-42/02, *Lindman*, 13 November 2003; C-364/01, *Barbier*, 11 December 2003; C-334/02, *Commission v France (fixed levy)*, 4 March 2004; C-9/02, *de Lasteyrie*, 11 March 2004; C-268/03, *De Baeck*, 8 June 2004; C-169/03, *Wallentin*, 1 July 2004; C-315/02, *Lenz*, 15 July 2004; C-242/03, *Weidert*, 15 July 2004; C-319/02, *Manninen*, 7 September 2004; C-219/03, *Commission v Spain*, 9 December 2004; C-39/04, *Laboratoires Fournier*, 10 March 2005.

[1184] C-250/95, *Futura*, § 23 *et seq.* The other aspect of the case, which was decided on the basis of the traditional discrimination-analysis, will be discussed in 2.E.I.A.a.1.c.

[1185] C-250/95, *Futura*, § 24-25: *"Such a condition may constitute a restriction, within the meaning of Article 52 of the Treaty, on the freedom of establishment of a company or firm […] where that company or firm wishes to establish a branch in a Member State different from that in which it has its seat. It means in practice that if such a company or firm wishes to carry forward any losses incurred by its branch, it must keep,* ***in addition to its own accounts*** *which must comply with the tax accounting rules applicable in the Member State in which it has its seat, separate accounts for its branch's activities complying with the tax accounting rules applicable in the State in which its branch is established. Furthermore, those separate accounts must be held, not at the company's seat, but at the place of establishment of its branch"* (emphasis added).

[1186] C-250/95, *Futura*, § 24 and 31 (emphasis added).

[1187] C-250/95, *Futura*, § 24 and 31; C-118/96, *Safir*, § 22-23 and 30; C-439/97, *Sandoz*, 18-20; C-55/98, *Vestergaard*, § 20-21; C-35/98, *Verkooijen*, § 34-36 and 46; C-17/00, *De Coster*, § 26 *et seq.*; C-136/00, *Danner*, § 29-30; C-436/00, *X & Y*, § 35-39 and 67-70; C-324/00, *Lankhorst-Hohorst*, § 27-32; C-385/00, *De Groot*, § 77-80 and 95; C-422/01, *Skandia*, § 25-28; C-168/01, *Bosal*, § 27; C-209/01, *Schilling*, § 24-26 and 37; C-364/01, *Barbier*, § 63; C-334/02, *Commission v France (fixed levy)*, § 23-25; C-9/02, *de Lasteyrie*, § 39-48; C-268/03, *De Baeck*, § 20-26; C-315/02, *Lenz*, § 20-22; C-242/03, *Weidert*, § 13-15; C-319/02, *Manninen*, § 20-24. Several other judgments handed down during this period, such as *AMID* and *Mertens*, contain less obvious references to the concept of restriction, such as the observation that national measures must not *"dissuade taxpayers from exercising their fundamental freedoms"*. However, the remainder of those judgments is framed in clear discrimination-language (unequal treatment, differentiation on the basis of the taxpayer's place of residence, etc.). Nevertheless, it is often difficult to determine whether the Court intended to decide a case under the restriction- or the discrimination-standard. Take for instance *Lankhorst-Hohorst*, in which the Court looks for

As mentioned before, the requirement that a measure might be *"liable to hinder or dissuade"* free movement is very easily fulfilled in the context of direct taxation. Accordingly, it should come as no surprise that a restriction was found to exist in all of the 20 cases referred to above in which the decision was framed in restriction-language. Consequently, in each of these cases the burden was shifted to the Member States in question to prove that the restriction was justified. Due to the Court's reluctance to accept justification grounds in the context of direct tax, these arguments failed in the vast majority of cases (more specifically, in 18 of the 20 cases[1188]).

c. The third generation: the return to discrimination

Starting with its judgment in *D*, the Court seems to have abandoned its attempts to apply a restriction-based reading of the Treaty in direct tax matters[1189]. The *D*-case, which will be discussed extensively in 2.E.I.A.b.1.a.9, concerned a tax-free allowance in the Dutch wealth tax[1190]. This allowance was only granted to residents of the Netherlands and, pursuant to the tax treaty between the Netherlands and Belgium, Belgian residents. The Court rejected the taxpayer's claim, thereby firmly establishing its reasoning in a discrimination-analysis. Referring to its traditional discrimination-case law, particularly *Schumacker*, the Court made a lengthy comparability-analysis and decided that German residents were not comparable to Dutch residents[1191]. As to the comparison with Belgian residents, the ECJ once again carried out its traditional discrimination-analysis, and held that German residents were not comparable to Belgian residents because of the specific nature of tax treaties[1192]. Under a pure restriction-based analysis, the line of reasoning would have been fundamentally different. The limitation of the tax allowance to Dutch and Belgian residents was undoubtedly restrictive for German residents owning real estate in the Netherlands. Ultimately, the case would then have to be decided on the basis of the justification grounds brought forward.

The next important step was taken in *Marks & Spencer*, a case involving the U.K. system of loss deductibility[1193]. The applicable U.K. measure allowed resident parent companies to offset losses incurred by their resident subsidiaries against their own profits. In contrast, resident parent companies with non-resident subsidiaries could not offset the losses incurred by their subsidiaries against their own profits, because such non-resident subsidiaries were

---

an 'obstacle' to the freedom of establishment in § 27-32 and refers to the national measure as a 'restriction' in § 27, while at the same time noting that the *"restriction introduces a difference in treatment between resident subsidiary companies according to whether or not their parent company has its seat in Germany."* Given this ambiguous use of language, it might seem difficult to categorize cases as being either applications of discrimination or restriction. As will become apparent in 2.D.V.C, however, the vast majority of these cases are clear discrimination-cases, despite their confusing use of words.

1188 The only two cases in which the justification grounds were accepted, were *Futura* and *Sandoz*. On *Futura*: see supra. *Sandoz* was actually a disparity-case (see infra), which means that the justification-issue should not have come up for discussion.

1189 Similarly: S. KINGSTON, "A light in the darkness: recent developments in the ECJ's direct tax jurisprudence", *Common Market Law Review* 2007, 1335, who refers to the period starting with *D* as "a coming of age in the Court's direct tax case law", characterised by a shift away from a simple restriction-based reading of the Treaty towards a more nuanced, sophisticated approach, grounded on discrimination. See also S. KINGSTON, "The boundaries of sovereignty: the ECJ's controversial role applying internal market law to direct tax measures", *Cambridge Yearbook of European Legal Studies*, Vol. 9, 303.

1190 C-376/03, *D v. Inspecteur van de Belastingdienst*, *ECR* 2005 I-05821, 5 July 2005.

1191 C-376/03, *D*, § 26-38.

1192 C-376/03, *D*, § 52 and 58-62.

1193 C-446/03, *Marks & Spencer*, *ECR* 2005 I-10837, 13 December 2005. This case will be addressed in more detail in 2.E.I.A.b.4.d.

only subject to U.K. tax on their profits insofar as these had been earned in the U.K. The taxpayer, a U.K. resident parent company, wanted to deduct from its own profits the losses incurred by its Belgian, French and German subsidiaries. In order to achieve this result, the taxpayer argued that the limitation of the tax benefit to resident parent companies with resident subsidiaries violated the freedom of establishment. Under a pure restriction-based approach, the measure would most likely be considered as liable to hinder the freedom of establishment of U.K. resident parent companies with non-resident subsidiaries. Accordingly, the focus would shift to the justification-test[1194]. However, the Court decided to take a more nuanced approach.

At first glance, the starting point of the ECJ's analysis seems to be the restriction-concept, as the Court decides in a first step that the U.K. measure was liable to hinder the exercise by U.K. resident parent companies of their freedom of establishment by deterring them from setting up subsidiaries in other Member States[1195]. The Court then goes on to apply its traditional three-step justification-test, i.e. whether the measure pursued a legitimate objective in the public interest, whether it was appropriate to attain that objective and whether it was proportional, but not before addressing the comparability of the situations[1196]. In doing so, the Court took a similar approach as the one taken in *D*.

In respect of the comparability-test, the U.K. government had argued that it was in accordance with the principle of territoriality that the Member State of establishment of the parent company has no tax jurisdiction over non-resident subsidiaries. Tax competence over non-resident subsidiaries belongs in principle to the State where they are established. In response to this argument, the Court first confirmed that residence may constitute a valid distinguishing factor in tax matters. However, the ECJ immediately added that *"residence is not always a proper factor for distinction."* Referring to *Avoir fiscal*, the Court stressed that acceptance of the proposition that Member States may apply different treatment solely because a company's registered office is in another Member State, would deprive the freedom of establishment of all meaning. It is therefore necessary in each specific situation to consider whether the fact that a tax advantage is available only to residents *"is based on relevant objective elements apt to justify the difference in treatment."* In the case at hand, the ECJ held that *"by taxing resident companies on their worldwide profits and non-resident companies solely on the profits from their activities in that State, the parent company's Member State is acting in accordance with the principle of territoriality enshrined in international tax law and recognised by Community law."* However, this fact in itself was not sufficient to render the situations incomparable in respect of the measure at issue. Unfortunately, the Court does not state why the situations **are** comparable; it only rejects the U.K. government's argument that they are incomparable because the national measure was in accordance with the principle of territoriality. In my opinion, the fact that the Court rejects this argument and immediately goes on to the justification-test, can mean two things. Either the Court implicitly accepts the situations at issue to be comparable unless the government argues convincingly that they are not, or the comparability-test is controlled by the justification-test (i.e. when the justification

---

[1194] Advocate-General Maduro apparently took this approach in his Opinion in *Marks & Spencer*. See particularly § 25-35 of the Opinion, which concludes with the observation that it is necessary *"to retain in tax matters the same concept of restriction on freedom of establishment which is applicable in the other areas. Thus 'all measures which prohibit, impede or render less attractive the exercise of that freedom' must be regarded as restrictions."*

[1195] C-446/03, *Marks & Spencer*, § 28-34.

[1196] C-446/03, *Marks & Spencer*, § 35-39.

grounds are convincing, the situations are incomparable). This question will be discussed in 2.E.I.A.b.4.d.

The Court then went on to identify three justification grounds for the measure: the need to protect a balanced allocation of the power to impose taxes between Member States, the danger that losses would be used twice and the risk of tax avoidance. Ultimately, the Court concluded from this analysis that the freedom of establishment did not preclude a measure such as the U.K. measure at issue. However, the Court added an important exception to this on the basis of the proportionality-requirement: it is contrary to the freedom of establishment to prevent the resident parent company from deducting the losses of its non-resident subsidiary where that subsidiary has exhausted the possibilities available in its State of residence of having the losses taken into account for past, present or future accounting periods[1197].

It may not be immediately apparent from the ECJ's use of words, but it seems that *Marks & Spencer* is a confirmation of the renewed emphasis on comparability that started with *D*, and more particularly the influence of the territoriality-principle on this assessment of comparability[1198]. In other words, it seems that a pure restriction-approach has been abandoned in these judgments, in favour of a more nuanced approach. Judging from the reasoning followed by the Court in these two decisions, it seems that this 'new' approach consists of three steps. First, the Court assesses whether the measure is liable to hinder the exercise of Treaty freedoms. Next, the Court considers whether the situations are comparable, having regard, in particular, to the influence of the territoriality principle. Finally, the Court analyses whether the measure is justified. This is essentially the traditional three-step discrimination-analysis, in which the comparability-test is determined by the influence of the territoriality principle and the disadvantage-test consists of verifying whether the exercise of the Treaty freedoms may be hindered.

This approach was subsequently confirmed in cases such as *ACT*, *FII*, *Thin Cap GLO* and *Denkavit*. *ACT*[1199] and *FII*[1200], the facts of which will be discussed at length in 2.E.I.A.b.6, both concerned the U.K. system of dividend taxation. While *ACT* concerned the tax treatment of outbound dividends (i.e. dividends paid by a U.K. subsidiary to a non-resident parent), *FII* dealt with the tax treatment of inbound dividends. The Court's starting point in both judgments is that comparable situations must receive the same treatment. For reasons set out in 2.E.I.A.b.6, the Court ultimately decided that the domestic and cross-border situation were incomparable as regards outbound dividends (meaning that the difference in treatment did not give rise to discrimination)[1201], while the domestic and cross-border situation were comparable as regards inbound dividends (meaning that the difference in treatment gave rise to discrimination)[1202]. Instead of merely pointing out that the legislation at issue may cause restrictions, the Court examines extensively whether the situations are comparable. If so, the Member State must refrain from treating the cross-border situation less favourably[1203]. In *Denkavit* (which will also be discussed in 2.E.I.A.b.6), the Court took the same approach[1204].

[1197] C-446/03, *Marks & Spencer*, § 55-56 and 59.
[1198] This issue will be addressed in detail in 2.E.I.A.b.4.
[1199] C-374/04, *Test Claimants in Class IV of the ACT Group Litigation*, 12 December 2006.
[1200] C-446/04, *Test Claimants in the FII Group Litigation*, 12 December 2006.
[1201] C-374/04, *ACT*, § 55-58 and 68.
[1202] C-446/04, *FII*, § 86-91.
[1203] See also C-524/04, *Test Claimants in the Thin Cap Group Litigation*, 13 March 2007, § 90.
[1204] C-170/05, *Denkavit Internationaal*, 14 December 2006, § 35.

V.C. Most 'restriction-cases' are actually discrimination-cases in disguise

a. Discrimination on the basis of the exercise of the free movement provisions

The evolution described above implies that the Court has not abandoned the discrimination-approach for a restriction-based reading of the Treaty. On the contrary, recent case law suggests a return to the traditional discrimination-approach. Moreover, many cases that are traditionally perceived as being applications of the restriction-based approach (i.e. the so-called 'second generation' cases), are actually discrimination-cases in disguise[1205].

The majority of this body of case law is composed of so-called outbound-cases. When comparing the Court's case law in this era to its very early decisions, there is a noticeable trend of extending the Treaty freedoms to outbound situations[1206]. As mentioned before, the traditional view was that the freedoms were mainly aimed at host State restrictions, thereby aiming to provide foreign nationals protection from discrimination when they moved to another Member State. However, the Court has evolved towards a broader understanding of the freedoms, and also considers home State restrictions on the freedoms[1207]. Even though the analysis of home State restrictions are well suited for a pure restriction-based reading of the Treaty, it is remarkable that the Court in substance applies a discrimination-based reading in such cases. For example, in *Safir*, the Court compared the situation of Swedish resident taxpayers who had taken out capital life assurance with companies established in other Member States with the situation of Swedish resident taxpayers who had taken out capital life

[1205] This section is only concerned with the 20 cases identified in footnote 1187, in which the Court's use of language seems to indicate that a restriction-test has been applied. Other 'second generation' cases, such as *ICI*, *X AB & Y AB*, *Baars*, etc. deal with similar issues, but the language used in those cases makes it clear that the Court carried out a discrimination-analysis. On the idea that many of the Court's direct tax cases that, due to the language used, give the impression that a restriction-analysis is carried out, are nevertheless applications of the non-discrimination test, see also K. BANKS, "The application of the fundamental freedoms to Member State tax measures: guarding against protectionism or second-guessing national policy choices", *European Law Review* 2008, 33(4), 482-506; J. SNELL, "Non-discriminatory tax obstacles in Community law", *International & Comparative Law Quarterly* 2007, 56(2), 339-370, J. ENGLISCH, "Taxation of cross-border dividends and EC fundamental freedoms", *Intertax* 2010, 202-203.

[1206] E.g. C-141/99, *AMID*, § 21: *"even though, according to their wording, the provisions concerning freedom of establishment are mainly aimed at ensuring that foreign nationals and companies are treated in the host Member State in the same way as nationals of that State, they also prohibit the State of origin from hindering the establishment in another Member State of one of its nationals or of a company incorporated under its legislation which comes within the definition contained in Article 58 of the Treaty."* Obviously, this idea was not entirely new, as there had been similar statements in earlier cases (e.g. 81/87, *Daily Mail*, § 16). Nevertheless, there is a remarkable number of such cases in this 'second generation' of case law.

[1207] The distinction between home State restrictions and host State restrictions is not the same as the distinction between 'active' and 'passive' market participants (who form both ends of an economic relationship). It has been very clear from the beginning that both active (e.g. employees) and passive market participants (e.g. employers) are protected by the fundamental freedoms. See for insance, in respect of the free movement of goods, Case 18/84, *Commission v France*, § 16 (the reservation of tax advantages to French newspaper publishers who had their newspapers printed by domestic printers violated Art. 34 TFEU, as it encouraged newspaper publishers to have publications printed in France rather than other Member States), in respect of the freedom to provide services, C-353/91, *Commission v Netherlands*, § 23 (Art. 56 TFEU was violated by the obligation for Dutch broadcasters to only make use of technical resources offered by domestic undertakings, as it prevented them from using the services of undertakings established in other Member States or, in any event, limited their opportunities of doing so), in respect of the free movement of capital, C-484/93, *Svensson and Gustavsson*, § 10, in respect of the free movement of workers, C-350/96, *Clean Car Autoservice*, § 20. On the 'passive' aspect of the freedom of establishment: cf. A. CORDEWENER, "The prohibitions of discrimination and restriction within the framework of the fully integrated internal market", in F. VANISTENDAEL (ed.), *EU Freedoms and direct taxation*, Amsterdam, IBFD Publications, 2006, 20-21.

assurance with companies established in Sweden[1208]. Similarly, in *Verkooijen*, the Court compared the situation of Dutch resident taxpayers in receipt of dividend income from shares in companies established in another Member State with that of Dutch resident taxpayers in receipt of dividend income from shares in companies established in the Netherlands[1209]. In both cases, the ECJ clearly compared the situation of the protected category of taxpayers with the purely domestic situation in order to assess whether the national measure was compatible with the EU Treaty. That is not a pure restriction-analysis, but a discrimination-analysis. As will be pointed out below, the only difference with a traditional analysis of discrimination on the basis of nationality, is that the comparison is no longer between nationals and non-nationals but between a person exercising his Treaty freedoms and a person not exercising those freedoms. This is also clear in *de Lasteyrie*, in which the ECJ compared the situation of a French resident taxpayer wishing to transfer his residence to another Member State with that of a French resident taxpayer who stays in France[1210]. Finally, in *Lenz*, the Court compared the situation of Austrian resident investors holding shares in companies established in other

[1208] C-118/96, *Safir*, § 24 *et seq.*

[1209] C-35/98, *Verkooijen*, § 34 *et seq.* Similar comparisons were also made in C-55/98, *Vestergaard*, § 21-22 (comparison between Danish resident taxpayers participating in professional training courses organised in other Member States and Danish resident taxpayers participating in professional training courses organised in Denmark), C-136/00, *Danner*, § 29-30 (comparison between Finnish resident taxpayers paying voluntary pension scheme contributions to pension providers established in other Member States and Finnish resident taxpayers paying voluntary pension scheme contributions to pension providers established in Finland), C-436/00, *X & Y*, § 35-39 and 67-70 (comparison between Swedish resident taxpayers transferring shares at undervalue to a company established in another Member State (or to a Swedish company with owners established in another Member State) and Swedish resident taxpayers transferring shares at undervalue to a Swedish company (or to a Swedish company with owners established in Sweden)), C-324/00, *Lankhorst-Hohorst*, § 27-32 (comparison between German resident companies making repayments in respect of loans obtained from a shareholder established in another Member State and German resident companies making repayments in respect of loans obtained from a shareholder established in Germany), C-385/00, *De Groot*, § 81-95 (comparison between Netherlands resident employees exercising part of their activities in other Member States and Netherlands resident employees exercising all their activities in the Netherlands), C-422/01, *Skandia*, § 26-28 (comparison between Swedish resident employers taking out occupational pension insurance with institutions established in other Member States and Swedish resident employers taking out occupational pension insurance with institutions established in Sweden), C-168/01, *Bosal*, § 12-13 (comparison between Netherlands resident parent companies with a subsidiary in another Member State and Netherlands resident parent companies with a subsidiary in the Netherlands); C-209/01, *Schilling*, § 33-37 (comparison between German residents who employ a household assistant for whom they pay contributions to the social security system of another Member State (their work State), and German residents who employ a household assistant for whom they pay contributions to the German social security system), C-364/01, *Barbier*, § 27 and 76 (comparison in the Dutch inheritance tax between the situation where the deceased was a resident of another Member State and where the deceased was a resident of the Netherlands), C-334/02, *Commission v France (fixed levy)*, § 23-25 (comparison between French resident taxpayers in receipt of interest paid by a debtor resident in another Member State and French resident taxpayers in receipt of interest paid by a debtor resident in France), C-268/03, *De Baeck*, § 20-26 (comparison between Belgian resident taxpayers securing gains in value on the transfer of shares in a Belgian company to a company established in another Member State and Belgian resident taxpayers securing gains in value on the transfer of shares in a Belgian company to a company established in Belgium), C-242/03, *Weidert*, § 13-15 (comparison between Luxembourg resident taxpayers holding shares in a company established in another Member State and Luxembourg resident taxpayers holding shares in a company established in Luxembourg) and C-319/02, *Manninen*, § 20 (comparison between Finnish resident taxpayers in receipt of dividends from a company established in another Member State and Finnish resident taxpayers in receipt of dividends from a company established in Finland).

[1210] C-9/02, *de Lasteyrie*, § 46: *"a taxpayer wishing to transfer his tax residence outside French territory, in exercise of the right guaranteed to him by Article 52 of the Treaty, is subjected to disadvantageous treatment in comparison with a person who maintains his residence in France. That taxpayer becomes liable, simply by reason of such a transfer, to tax on income which has not yet been realised and which he therefore does not have, whereas, if he remained in France, increases in value would become taxable only when, and to the extent that, they were actually realised."*

Member States with that of Austrian resident investors holding shares in companies established in Austria[1211].

Consequently, even though these cases are at first glance applications of a restriction-based reading, they are actually discrimination-cases in disguise. In other words, even in oubound situations, which are perfectly suited for a pure restriction-based reading, the Court has not shifted towards a restriction-based analysis, but rather seems to adhere to the idea that the Internal Market requires equal treatment between cross-border situations and purely internal situations. This is, in substance, a discrimination-analysis. However, the comparison is no longer between nationals and non-nationals (or, indirectly, between residents and non-residents), but between a person exercising his fundamental freedoms and a person not exercising those freedoms (e.g. a self-employed person working in another Member State as compared to a self-employed person working in his home State, an investor investing in another Member State as compared to an investor investing in his home State, etc.)[1212].

> In this respect, reference should be made to what has been said in Part I, B.I on the elements of discrimination. As pointed out there, one of the four components of discrimination is that the rule at issue must distinguish on the basis of a prohibited criterion. In the ECJ's case law, criteria are prohibited when they distinguish on the basis of a cross-border element, such as the fact that services are obtained from a service provider established in another Member State. That is a preliminary issue to be addressed before the Court assesses comparability and the existence of a disadvantage: if the rule at issue makes no distinction on the basis of a prohibited criterion, there can be no discrimination.
>
> In *Eurowings* (see 2.E.I.B.d.1), for instance, the German government argued that there was no discrimination because the add-backs were applied when the lessor was not liable to trade tax, regardless of whether he was established in Germany or in another Member State[1213]. In other words, the German government argued that no distinction

---

[1211] C-315/02, *Lenz*, § 21: *"to the extent that revenue from capital originating in another Member State receives less favourable tax treatment than revenue from capital of Austrian origin, the shares of companies established in other Member States are, for investors living in Austria, less attractive than the shares of companies established in that Member State."*

[1212] See also P. FARMER, "The Court's case law on taxation: a castle built on shifting sands?", *EC Tax Review* 2003, 77, who notes that such outbound cases are not concerned with discrimination on grounds of nationality *"but discrimination against the exercise of the Treaty freedoms."* And further, at 81: *"Except for [the accounting requirement in Futura], all the obstacles which the Court had to consider could be said to be discriminatory."* Similarly, R. LYAL, "EU Report", in IFA, *Cahiers de droit fiscal international. Non-discrimination at the crossroads of international taxation*, Vol. 93a, Amersfoort, Sdu Fiscale & Financiële Uitgevers, 2008, 66: *"in determining whether a measure can be said to deter someone from making use of a Treaty freedom the Court essentially engages in a comparative exercise, assessing whether national legislation makes outbound movement less attractive than simply staying at home. For that reason it seems legitimate to regard the Court's interpretation of the freedoms as tantamount to a rule prohibiting discrimination against cross-border transactions or movement in comparison with purely domestic situations. It is true that for some years now the Court's case law on direct taxation, following the trend in its general case law on the freedoms, has adopted the language of restriction in describing the criteria which govern their interpretation. […] Nevertheless, the Court's logic does not correspond to its language. In determining the existence of an obstacle to free movement, it consistently focuses on the existence of a difference in treatment between domestic and cross-border situations. […] It is clear, therefore, that what is in issue is not some abstract or inherent character of restrictiveness to be found in the legislation but a difference in treatment which is not justified. That is the logic of discrimination."* Similarly, M. LANG"Recent case law of the ECJ in direct taxation: trends, tensions and contradictions", *EC Tax Review* 2009, 99 and 113: *"in the freedoms cases, it is always possible to identify comparable situations, even in situations that, at first sight, give the impression that a mere 'restriction approach' is required."*

[1213] C-294/97, *Eurowings*, 26 October 1999, § 24-25.

> was made on the basis of a cross-border element: the distinction being made was solely on the basis of liability to trade tax. However, the Court dismissed that argument and pointed out that the add-backs **always** applied when German taxpayers leased goods from lessors established in another Member State, since those lessors are never liable to trade tax, while that obligation did not apply, in most cases, when the lessors were established in Germany since they were generally liable to trade tax[1214]. Therefore, the rule did in fact distinguish on the basis of a cross-border element, albeit indirectly, by referring to liability to trade tax.

As mentioned earlier, non-discrimination is essentially the prohibition to treat a protected category less favourably, i.e. the prohibition to distinguish on the basis of a specific criterion. In contrast, non-restriction is an absolute analysis, one that seeks to ascertain free movement without verifying whether a distinction has been made on the basis of a prohibited criterion[1215]. Therefore, when a national tax measure distinguishes on the basis of a prohibited criterion, it should be analysed under the discrimination-test. Only when there is no distinction (or no distinction on the basis of a prohibited criterion) should the restriction-test be applied. In my opinion, the EU Treaties not only protect EU-citizens from discrimination on the basis of nationality. The wording and structure of the free movement provisions demonstrate that free movement as such is a protected activity. That is to say, the Treaty tries to protect EU citizens exercising their free movement from less favourable treatment as compared to EU citizens not exercising those freedoms[1216]. If not, the freedoms would be devoid of any practical meaning. Accordingly, EU citizens exercising their Treaty freedoms constitute a protected category under the Treaty, and should therefore be protected from discrimination on the basis of their defining criterion (the exercise of the freedoms). In other words, national measures that make a distinction on the basis of the exercise of a Treaty freedom should be analysed under the discrimination-test, rather than the restriction-test[1217].

Consequently, these 'outbound'-cases are not concerned with issues of restriction, but with issues of discrimination, the comparison being made between economic actors pursuing cross-border transactions and economic actors engaged in equivalent activities within one Member State[1218]. From a substantive point of view, the analysis to be applied is exactly the same as in

---

[1214] C-294/97, *Eurowings*, 26 October 1999, § 35-36.
[1215] For instance in *Futura*, there was no distinction at all. The restriction resulted from the cumulative application of different systems. Of course, the restriction only becomes visible by comparing it to a situation in which it does not exist, particularly the situation of a taxpayer subject to a single set of rules. However, the measure at issue did not make any distinction on the basis of a prohibited criterion: it was completely neutral in every respect.
[1216] See also C-224/98, *D'Hoop*, 11 July 2002, § 30-31 (on citizenship): *"In that a citizen of the Union must be granted in all Member States the same treatment in law as that accorded to the nationals of those Member States who find themselves in the same situation, it would be incompatible with the right of freedom of movement were a citizen, in the Member State of which he is a national, to receive treatment less favourable than he would enjoy if he had not availed himself of the opportunities offered by the Treaty in relation to freedom of movement. Those opportunities could not be fully effective if a national of a Member State could be deterred from availing himself of them by obstacles raised on his return to his country of origin by legislation penalising the fact that he has used them"*. Similarly, C-224/02, *Pusa*, 29 April 2004, § 18-19.
[1217] See also R. LYAL, "Non-discrimination and direct tax in Community law", *EC Tax Review* 2003, 74: *"we should not take too narrow a view of the concept of discrimination on the basis of nationality: we should be willing to regard as discriminatory all measures which give less favourable treatment to a trans-frontier situation than to a purely domestic situation, whether that relates to incoming or outgoing movement of workers, capital, services, establishment of business."*
[1218] Similarly, J. ENGLISCH, "The European Treaties' implications for direct taxes", *Intertax* 2005, 314.

‘traditional’ discrimination cases (i.e. unfavourable treatment of non-nationals in the host State), but the difference lies in the object and the subject of comparison[1219].

The question thus arises whether this difference at the level of object and subject of comparison warrants a fundamentally different analysis. As noted earlier, the main difference between a discrimination- and a restriction-analysis is the absence of any reference to comparability in the latter. Non-restriction requires that the exercise of the fundamental freedoms is not hindered (disadvantage-test), unless it is justified (justification-test). So a restriction-analysis is not based on a comparison with the domestic situation, since it only verifies whether the cross-border activity is hindered. The reason why there is no comparability-test in a pure restriction-based case, is that restriction is an absolute concept, which does not require any comparison to be made (see supra). Clearly, that is not what was at issue in the outbound-cases referred to here. In these cases, the restriction was caused by the less favourable treatment as compared to the domestic situation. The restriction was never assessed *in vacuo* since it only existed because the domestic situation received more favourable tax treatment. As mentioned earlier, the reason why the Court is reluctant to call this a ‘discrimination’ is the vague wording of the Treaty, but substantively, these are clearly discrimination-cases. Since the cases referred to here are not actual restriction-cases, it is questionable whether the comparability-test should be left aside.

b. Examples

In *Sandoz*, the Court had to deal with an Austrian stamp duty on loans contracted by resident borrowers[1220]. Even though this is an indirect tax case, it illustrates the confusion and contradictions that characterise this era of the Court’s tax case law. The Austrian duty applied to all Austrian residents who entered into a contract for a loan irrespective of the nationality of the contracting parties or of the place where the loan was contracted. Nevertheless, the ECJ held that the levy of the duty on loans contracted with a non-resident lender constituted a restriction on the free movement of capital. According to the Court, the measure deprived Austrian residents *“of the possibility of benefiting from the absence of taxation which may be associated with loans obtained outside the national territory. Accordingly, such a measure is likely to deter such residents from obtaining loans from persons established in other Member States”*[1221]. At first glance, this seems to be an application of the restriction-approach. However, it is not clear to me why this is not a disparity. The mere observation that the Austrian measure deprived residents of the possibility of tax-neutral treatment, even though other Member States do not levy a similar duty, does not elevate this case above a disparity-

[1219] Once again, the vague wording of the Treaty has been said to cause this dichotomy in the Court’s case law. In particular, it seems that the ECJ’s reluctance to use the term ‘discrimination’ in outbound situations may be explained by the lack of reference to ‘discrimination’ in the Treaty as regards outbound situations. The guarantee of ‘national treatment’ only makes sense in inbound situations, and the only clauses that could be considered to cover outbound situations are those prohibiting ‘restrictions’ or guaranteeing ‘free movement’; cf. A. CORDEWENER, “The prohibitions of discrimination and restriction within the framework of the fully integrated internal market”, in F. VANISTENDAEL (ed.), *EU Freedoms and direct taxation*, Amsterdam, IBFD Publications, 2006, 17.
[1220] C-439/97, *Sandoz*, 14 October 1999. *Sandoz* also concerned another aspect of the Austrian tax treatment of loans: loans contracted by residents with a non-resident lender were subject to tax in circumstances where a loan contracted with a resident lender would not be subject to tax. This difference in treatment clearly amounted to discrimination, and the Court’s use of words leaves no doubt that the analysis carried out in this respect was an application of the discrimination-test (see, in particular, § 30-31).
[1221] C-439/97, *Sandoz*, § 19.

issue[1222]. There is no 'restriction' if there is a national tax that does not exist in other Member States. The 'disadvantage' stemming from the fact that some taxpayers are subject to that tax while other are not, is simply the result of the existence of 27 discrete national tax systems.

Moreover, the Court ultimately considered the Austrian measure to be justified because it was necessary to prevent infringements of national law. The Austrian government had argued that the measure was *"justified by the need to observe the principle that residents should be treated equally for tax purposes."* The idea behind this argument seems to be that the Austrian government wanted to ensure that every Austrian resident paid the duty, even if the loan was contracted in another Member State or with a non-resident lender. The ECJ agreed, observing that the main objective of the measure was to ensure equal tax treatment for all Austrian residents. The Court went on: *"since the effect of such a measure is to compel [resident borrowers] to pay the duty, it prevents taxable persons from evading the requirements of domestic tax legislation through the exercise of freedom of capital."* This line of reasoning is quite remarkable. In effect, the Court first decides that a neutral measure is, prima facie, contrary to EU law, only to decide that it is justified **because it was neutral**, with the additional argument that its effect was *"to compel resident borrowers to pay it"* thereby preventing tax evasion. In other words, the Court decides that a measure that treats domestic and cross-border situations equally is restrictive, but that it is ultimately justified because it is intended to ensure equal treatment of domestic and cross-border situations. Such an interpretation would in fact be able to justify all neutral tax measures[1223]. Perhaps this strained reasoning can be explained by what has been suggested above: the 'restrictive' effect identifed by the Court was nothing more than the result of the interplay of different tax systems, and should therefore fall outside the scope of the Treaty freedoms[1224].

Another indirect tax case that is sometimes referred to as an example to demonstrate the Court's willingness to apply a restriction-approach in tax matters is *De Coster*[1225].

[1222] See also A. CORDEWENER, "The prohibitions of discrimination and restriction within the framework of the fully integrated internal market", in F. VANISTENDAEL (ed.), *EU Freedoms and direct taxation*, Amsterdam, IBFD Publications, 2006, 28.

[1223] See also J. SNELL, "Non-discriminatory tax obstacles in Community law", *International & Comparative Law Quarterly* 2007, 56(2), 345-346.

[1224] See also K. BANKS, "The application of the fundamental freedoms to Member State tax measures: guarding against protectionism or second-guessing national policy choices", *European Law Review* 2008, 33(4), 493-493, who notes that *"this somewhat tortured approach is evidence of the fact that the drafters of the Treaty provisions on free movement of capital never envisaged entirely neutral tax measures being treated as restrictions, and therefore provided no suitable 'let-out' clause for them."*

[1225] C-17/00, *François De Coster v Watermaal-Bosvoorde*, 29 November 2001. For a similar case, see Joined Cases C-544/03 and 545/03, *Mobistar SA v Commune de Fléron, Belgacom Mobile SA v Commune de Schaerbeek*, concerning local taxes on transmission pylons, masts and antennae for GSM. Two Belgian mobile telephony operators argued that these taxes constituted a restriction contrary to the freedom to provide services. The Court first noted that *"measures, the only effect of which is to create additional costs in respect of the service in question and which affect in the same way the provision of services between Member States and that within one Member State, do not fall within the scope of Article [49] of the Treaty."* As to the case at hand, the Court pointed out that the taxes at issue applied *"without distinction to all owners of mobile telephone installations within the commune in question, and that foreign operators are not, either in fact or in law, more adversely affected by those measures than national operators. Nor do the tax measures in question make cross-border service provision more difficult than national service provision. Admittedly, introducing a tax on pylons, masts and antennae can make tariffs for mobile telephone communications to Belgium from abroad and vice versa more expensive. However, national telephone service provision is, to the same extent, subject to the risk that the tax will have an impact on tariffs."* Finally, the Court did not address the double burden-issue because there was *"nothing in the file to suggest that the cumulative effect of the local taxes compromises freedom to provide mobile telephony services between other Member States and the Kingdom of Belgium"* (Joined Cases C-544/03 and 545/03, *Mobistar*, § 31-34).

That case concerned a Belgian municipal tax on satellite dishes, a measure which applied without any distinction on the basis of nationality. The Court decided that the measure constituted a restriction on the freedom to provide services because it had the effect of a charge on the reception of television programmes transmitted by satellite which did not apply to the reception of programmes transmitted by cable. However, the reasoning of the Court was based on a discrimination-analysis rather than a restriction-analysis. The reason why the measure was incompatible with the freedom to provide services was that broadcasters established in Belgium enjoyed unlimited access to cable distribution for their programmes in that Member State, while broadcasters established in other Member States generally did not. As a result, the measure at issue was likely to dissuade the recipients of the television broadcasting services established in the municipality in question from seeking access to television programmes broadcast from other Member States, since the reception of such programmes was subject to a charge which did not apply to the reception of programmes coming from broadcasters established in Belgium.

In other words, the Court decided that the measure was more disadvantageous to foreign service providers than it was to Belgian service providers: *"the tax on satellite dishes introduced by the tax regulation* ***is liable to impede more*** *the activities of operators in the field of broadcasting or television transmission established in Member States other than the Kingdom of Belgium, while giving an advantage to the internal Belgian market and to radio and television distribution within that Member State"*[1226]. Clearly, that is a discrimination-analysis.

c. Futura

Ultimately, there are very few 'real' restriction-cases in the field of direct taxation[1227]. The most obvious example is *Futura* (see supra), a rare instance where the mutual recognition-doctrine was applied in direct tax matters. As mentioned earlier, the concept of mutual recognition has mainly been applied in the context of the free movement of goods and services[1228]. The basic idea underlying that concept is the following. When a good is put on the market in a Member State (the origin State), that State can apply its own rules. If the good is later exported to another Member State, that State (the host State) is required to recognize the rules of the origin State, unless there is a justification for not doing so. Dual burdens are therefore prohibited, unless they can be justified. In *Futura*, the Court held that the host State (Luxembourg) was in principle required to recognize the accounting rules imposed by the origin State (France), unless there was a justification for refusing to do so.

As regards the justification, the Court also addresses some aspects that were relevant for the determination that there was a restriction. After establishing that the Luxembourg measure constituted a restriction because it imposed a double burden on

[1226] C-17/00, *De Coster*, § 35 (emphasis added).
[1227] Similarly, S. VAN THIEL, "The future of the principle of non-discrimination in the EU: towards a right to most favored nation treatment and a prohibition of double burdens?", in R. AVI-YONAH, J. HINES and M. LANG (eds.), *Comparative fiscal federalism*, Alphen aan den Rijn, Kluwer Law International, 2007, 394: *"in its general case law the Court has gradually moved from a discrimination-based to a restriction-based reading of the Treaty, at least as regards market access (not necessarily as regards market exit. […] In the tax area a similar approach was followed for indirect taxes and social security contributions, but not (yet) for income taxes. In fact the Court has been reluctant to prohibit non-discriminatory access taxes explicitly in its income tax case law (except in Futura)."*
[1228] Applications in the field of other freedoms are quite rare. It could be argued that *Centros*, *Inspire Art* and *Überseering* were applications of mutual recognition in the field of the freedom of establishment. In those cases, the ECJ decided that the host State is required to recognize companies that are formed under the law of another Member State, without imposing additional national requirements.

non-residents with a PE in Luxembourg[1229], the Court verifies whether it pursued a legitimate aim compatible with the Treaty. The aim pursued by the Luxembourg accounting requirement was to make sure that the losses in question did in fact arise from Luxembourg activities, that the amount of the losses corresponded, under Luxembourg rules on the calculation of income and losses, to the amount of losses actually incurred by the taxpayer and, finally, to enable the Luxembourg tax authorities to inspect the accounts at any time[1230].

The Court recognizes that, since the effectiveness of fiscal supervision may justify a restriction, a Member State is allowed to apply measures that enable the amount of the income taxable in that State and the losses which can be carried forward there to be ascertained clearly and precisely. On the one hand, the Court then points out that the objectives pursued by the Luxembourg measure would not be attained if the Luxembourg authorities had to refer to accounts kept by the non-resident taxpayer pursuant to another Member State's rules. Since there was no EU harmonization on the determination of the taxable base, each Member State has its own rules governing the determination of profits and losses. As a result, there was no guarantee that a company's accounts drawn up for the purpose of determining the taxable base in its home State would provide relevant figures concerning the amount of taxable income and of the losses which could be carried forward in the PE State.

On the other hand, the Court examines whether the requirement of keeping separate accounts in Luxembourg **goes beyond what is necessary** to enable the amount of losses that can be carried forward to be ascertained. In that respect, the Court observes that, under Luxembourg law, non-resident taxpayers are not, as a rule, obliged to keep proper accounts relating to their Luxembourg activities. As a result, the Luxembourg authorities are unable to inspect the accounts. It is only when a non-resident taxpayer asks to be allowed to carry forward losses that he is obliged to show that he kept proper accounts relating to his activities in Luxembourg. However, once such a request is made, the sole concern of the Luxembourg authorities is to ascertain clearly and precisely that the amount of losses to be carried forward corresponds, under the Luxembourg rules on the calculation of income and losses, to the amount of losses actually incurred in Luxembourg by the taxpayer[1231]. Consequently, *"provided that the taxpayer demonstrates, clearly and precisely, the amount of the losses concerned, the Luxembourg authorities cannot refuse to allow him to carry them forward on the ground that in the year concerned he had not kept and not held in Luxembourg proper accounts relating to his activities in that State."*

The Court therefore holds that it is not essential that the means by which the non-resident taxpayer may demonstrate the amount of the losses he seeks to carry forward be limited to those provided for by Luxembourg law. Additionally, the Mutual

[1229] C-250/95, *Futura*, § 23-25: *"Such a condition may constitute a restriction, within the meaning of Article 52 of the Treaty, on the freedom of establishment of a company or firm […] where that company or firm wishes to establish a branch in a Member State different from that in which it has its seat. It means in practice that if such a company or firm wishes to carry forward any losses incurred by its branch, it must keep, in addition to its own accounts which must comply with the tax accounting rules applicable in the Member State in which it has its seat, separate accounts for its branch's activities complying with the tax accounting rules applicable in the State in which its branch is established. Furthermore, those separate accounts must be held, not at the company's seat, but at the place of establishment of its branch"* (see supra).
[1230] C-250/95, *Futura*, § 28-29.
[1231] This seems to be a rebuttal of the argument of Luxembourg that the measure was necessary to enable the Luxembourg tax authorities to inspect the accounts at any time. According to the Court, there was no need to inspect the accounts of a non-resident taxpayer at any time. Only when such a taxpayer applies for a loss carry-forward, is it necessary to inspect his accounts. And at that time, the only concern of the tax authorities is to ascertain clearly and precisely the amount of losses to be carried forward.

> Assistance Directive allows the Luxembourg tax authorities to request the competent authorities of another Member State to provide them with all the information enabling them to ascertain, in relation to the legislation which they have to apply, the correct amount of revenue tax payable by a taxpayer having his residence in that other Member State[1232].
>
> In other words, for **the existence** of a restriction, the Court apparently considers it sufficient that there is a double burden, without ascertaining whether the aim pursued by the measure imposing the double burden is actually achieved by the legislation of another Member State. For the **justification** of that restriction, the Court does consider whether the other State's legislation does in fact achieve the same objective (e.g. because the relevant legislation has been harmonized). This is an interesting distinction, but it is not immediately clear what the underlying reason is. As will be discussed below, the application of a restriction-approach is not possible with respect to matters of substantive domestic tax law. Only other matters, i.e. what will be called 'procedural' tax law, are suited for a restriction-analysis.

It should be stressed at this point that the aspect of *Futura* discussed here was not of a substantive nature. The accounting rules to which the Court applied the concept of mutual recognition were elements of procedural law. It is very doubtful whether the Court would extend such a pure restriction-based approach to cases involving substantive tax matters, as mutual recognition of substantive tax rules is quite far-reaching, given the tax sovereignty of Member States[1233]. The Court considers disadvantages arising from the fact that a taxpayer is subject to another (i.e. a second) tax system, with its own substantive rules, to be an allowed disparity (see infra, 2.II).

Accordingly, double burdens in substantive tax matters resulting from being subject to more than one tax system do not come within the scope of the Treaty freedoms[1234]. The mere fact that the different substantive tax rules of the Member States exist side-by-side cannot give rise to a breach of the Treaty freedoms, even though a taxpayer may be 'restricted' from exercising his treaty freedoms as a result of this coexistence. An obvious example of this position is *Kerckhaert-Morres*[1235]. In that case, the Court decided that Belgium did not breach the Treaty freedoms by applying a neutral tax measure to all income, regardless of the fact that the same income had already been taxed in another Member State. The Belgian measure at issue did not make any distinction between dividends from companies established in Belgium and dividends from companies established in another Member State. Both categories of dividends were taxed by way of income tax at an identical rate of 25 %. Consequently, the Belgian measure was truly even-handed. However, it was clearly liable to dissuade cross-

[1232] C-250/95, *Futura*, § 31-41.

[1233] See also M. AUJEAN, "The future of non-discrimination. Direct taxation in Community law", in R. AVI-YONAH, J. HINES and M. LANG (eds.), *Comparative fiscal federalism*, Alphen aan den Rijn, Kluwer Law International, 2007, 324: *"In its non-tax case law the Court has repeatedly held that non-discriminatory restrictions to the free movement of goods are impermissible unless justified by imperative requirements of public interest. In the direct tax sphere the Court has so far only applied this analysis unequivocally to compliance issues (see Case C-250/95, Futura Participations)"*.

[1234] See also P. FARMER, "EC law and national rules on direct taxation: a phoney war", *EC Tax Review* 1998, No. 1, 27, who noted shortly after the *Futura*-judgment that a dual approach could arise in the Court's case law, based on discrimination in relation to tax burden and restriction in regard to compliance. Limiting the analysis in relation to tax burden to discrimination avoids bringing restrictions arising from the mere exercise of tax jurisidiction or from conflicts of jurisdiction within the scope of the Treaty freedoms. On the other hand, compliance-issues, such as the accounting obligation in *Futura*, lend themselves more readily to a restriction-based approach.

[1235] C-513/04, *Kerckhaert-Morres*, 14 November 2006. This case will be addressed in more detail in 2.E.I.A.b.6.

border investment, as the dividends which the taxpayer received from a French company had already been taxed in France. Nevertheless, the ECJ does not consider this 'double burden' to fall foul of the Treaty. According to the Court, the adverse consequences which might arise from the application of the Belgian legislation *"result from the exercise in parallel by two Member States of their fiscal sovereignty."* From this refusal to recognize the existence of a restriction, one could infer that the Court considers substantive direct tax measures to be unsuited for a restriction-analysis[1236]. If the Court had applied its mutual recognition-doctrine, as it did to the procedural rules of *Futura*, Belgium would have had to 'recognize' the taxation in France and refrain from further taxation.

The Court took the same position in *CIBA*[1237], which concerned the Hungarian vocational training levy. Companies established in Hungary were subject to a tax, calculated on the basis of their wage costs, which was intended to finance a fund that served to increase the number of trained specialists in Hungary and to develop their professional skills. The taxpayer was a company established in Hungary with a PE in the Czech Republic. In the latter State, the taxpayer paid taxes and social security contributions in respect of the workers employed in the PE, including contributions relating to public policy on employment, as laid down in Czech domestic law. The taxpayer argued that the Hungarian measure infringed the freedom of establishment because the basis of assessment for the vocational training levy was the taxpayer's total wage cost, including the wages incurred at the Czech PE. Because the Hungarian measure applied to the total wage cost, the taxpayer was subject to a double obligation to pay such a contribution in respect of its workers employed in the Czech Republic.

Referring to *Kerckhaert-Morres*, the ECJ dismissed the taxpayer's claim. The Court held that the disadvantage incurred by the taxpayer – i.e. the double burden of paying similar contributions in Hungary and the Czech Republic with respect to the workers employed in the Czech PE – resulted *"from the exercise in parallel by two Member States of their fiscal sovereignty"*. Since there are no harmonisation measures to eliminate double taxation at the EU level, the Member States enjoy a certain autonomy in this area, meaning that they are not obliged to adapt their own tax systems to the different tax systems of the other Member States in order to eliminate the double taxation arising from the exercise in parallel by those States of their fiscal sovereignty. Therefore, the double taxation incurred by the taxpayer was not contrary to the Treaty freedoms[1238].

[1236] Similarly: C-298/05, *Columbus Container Services*, 6 December 2007, § 43-45, which will be discussed in 2.E.I.B.a.2.

[1237] C-96/08, *CIBA Speciality Chemicals Central and Eastern Europe Szolgáltató, Tanácsadó és Keresdedelmi kft*, 15 April 2010.

[1238] C-96/08, *CIBA*, § 25-29. Similarly, C-67/08, *Block*, 12 February 2009, § 28, concerning the German inheritance tax on capital assets invested with financial institutions in Spain. Double taxation arose because Germany made capital claims subject to German inheritance tax if the creditor was resident in Germany, while Spain made such claims subject to Spanish inheritance tax if the debtor was established in Spain. The ECJ held that the refusal by the German tax authors to grant a credit for the tax paid in Spain was not contrary to the free movement of capital because the disadvantage resulted from the exercise in parallel by the two Member States concerned of their fiscal sovereignty. Reference should also be made to C-234/99, *Nygård*, 23 April 2002, concerning the free movement of goods. When discussing whether a Danish (non-discriminatory) charge on the slaughter of pigs was compatible with Article 90 EC (current Art. 110 TFEU), the ECJ held that it was irrelevant that the Member State of importation also levied a similar charge, even though this resulted in a double burden (C-234/99, *Nygård*, § 38: *"As it stands at present, Community law does not contain any provision designed to prohibit the effects of double taxation occurring in the case of charges, such as that in issue in the main proceedings, which are governed by independent national legislation, and, while the elimination of such effects is desirable in the interests of the free movement of goods, it may none the less result only from the*

It has been suggested that the Court's refusal to apply the mutual recognition-doctrine in *Kerckhaert-Morres* is inconsistent with its earlier case law, notably *Marks & Spencer* and *Manninen*[1239]. In *Marks & Spencer*, the Court required the home State to consider the deductions available in the host State when deciding whether to accept a deduction under domestic law[1240]. This is quite similar to requiring a Member State to consider the taxation in another State when deciding on the imposition of a tax under domestic law (i.e. mutual recognition). In *Manninen*, the Court required a Member State that granted resident shareholders in receipt of domestic dividends a tax credit corresponding to the domestic corporate tax on the profits, to extend that credit to foreign dividends. One could argue that this entails the mutual recognition of a foreign tax for the purpose of granting a tax credit.

However, it should be stressed here that the measure at issue in *Kerckhaert-Morres* applied without any distinction, while the national measures in *Marks & Spencer* and *Manninen* distinguished on the basis of the subsidiaries' State of residence and the source of the dividends, respectively. Accordingly, *Kerckhaert-Morres* required a restriction-analysis, which explains why the Court verified whether the mutual recognition-doctrine could be applied. As argued above, this proved to be impossible because it concerned substantive tax rules. In contrast, *Marks & Spencer* and *Manninen* concerned discriminatory rules, which means that the mutual recognition-doctrine was irrelevant. In those cases, the taking into account of the taxation in the other Member State was part of the disadvantage-test of the discrimination-analysis. In particular, in order to verify whether the subject of comparison was being treated less favourably (and in order to assess the extent of that disadvantage, which determined the proportionality of the measure), the Court verified in *Marks & Spencer* whether there was a possibility to deduct the losses in the subsidiary's State of residence. Similarly, in *Manninen*, the disadvantage incurred by the subject of comparison was the double taxation which was relieved for domestic dividends but not for cross-border dividends (and which, in the latter case, required the taking into account of the taxation in the other Member State).

That is not the same as 'recognizing' that the tax measure in the other Member State already fulfills the objective sought by the measure under scrutiny, and therefore refraining from further taxation. There is an important difference between mutual recognition of substantive tax measures (which goes beyond the scope of the Treaty freedoms) and taking account of what happens in another State when assessing the existence and the extent of a disadvantage.

Ultimately, that is the reason why the evolution perceived in the Court's general body of case law, from discrimination to restriction, cannot be transposed to substantive direct tax matters. Non-discriminatory restrictions resulting from the cumulation of the substantive tax laws of different Member States hinder the development of the Internal Market, but they go beyond the scope of the Treaty freedoms as they are the result of disparities. In order to reduce or eliminate the distortive effects of these 'restrictions', Member States have two options. Either they replace the national systems with one uniform or harmonized system in which cumulation of burdens is avoided (which is unlikely, given the procedural requirements for

harmonisation of national systems"). Similarly, C-517/04, *Koornstra*, 8 June 2006, concerning a Dutch charge on the landing of shrimp.

1239 E.g. J. SNELL, "Non-discriminatory tax obstacles in Community law", *International & Comparative Law Quarterly* 2007, 56(2), 361-362.

1240 See *Marks & Spencer*, § 55: the denial of deduction by the resident parent is disproportionate if it was impossible to take the losses into account in the subsidiary's State of establishment.

direct tax harmonization in the EU), or they choose one of the substantive systems to be applicable to a particular situation (whether it be that of the home State or that of the host State). The latter option is, to some extent, developed in international tax law, where tax treaties designate which State has the power to tax a certain element of income. However, this allocation of taxing powers is an element of the Member States' sovereignty, and therefore not a matter of EU law.

Moreover, one should keep in mind that the mutual recognition-doctrine, as developed in *Cassis de Dijon*, is based on the idea that a Member State cannot apply its own rules because the interests it seeks to protect by the application of those rules are already protected by the rules of another Member State. More specifically, the idea underlying mutual recognition is that a Member State is not allowed to impose its product requirements that are intended, for example, to protect public health if that objective is already safeguarded by the product requirements that are applicable in the Member State of origin. That idea cannot be transposed to the field of substantive direct taxation. The interest protected by the application of a Member State's substantive tax law is the collection of revenue for that State. Obviously, this interest is not safeguarded by the application of another Member State's substantive tax law: taxation by one Member State does not benefit the treasury of another Member State. Consequently, one cannot argue that the interests which a Member State's substantive tax law seeks to protect are already protected by another Member State's rules. Therefore, the former Member State is not required to 'recognize' the taxation in the latter Member State (i.e. no mutual recognition).

In contrast, certain procedural tax rules of different Member States may very well protect the same interests. Take, for instance, the rules at issue in *Futura*. The obligation to keep separate accounts sought to protect the interest of the PE State to be able to ascertain the amount of losses connected with the PE. However, that interest was already protected by the obligation to keep accounts in the home State, and the Mutual Assistance Directive allowed the PE-State to request the taxpayer's home State to provide them with the relevant information[1241]. Consequently, the interest that the PE-State's rules sought to protect was already covered by the taxpayer's home State rules. Therefore, the PE-State was required to 'recognize' those rules (i.e. mutual recognition).

d. Commission v Belgium

Another example where the Court applied a pure restriction-based reading of the Treaty freedoms was C-433/04, *Commission v Belgium*[1242]. The national legislation at issue in this case was introduced in order to prevent tax fraud in the construction sector. Under that legislation, a principal who paid a contractor to do construction work was required to withhold 15% of the sum invoiced and pay that amount to the tax authorities if the service provider was not registered as a contractor in Belgium. Moreover, a principal who had recourse to a non-registered contractor was jointly and severally liable for the payment of that contractor's tax debts.

The amounts paid in accordance with the withholding obligation were deducted from the sum for which the principal was made responsible. If the withholding had not taken place, an administrative fine was levied on the principal. It was possible to recover the sums withheld

[1241] See, in particular, *Futura*, § 30 and 39-42.
[1242] C-433/04, *Commission v Belgium*, 9 November 2006.

to the extent to which they were not allocated to the payment of tax debts, but, for that purpose, a request had to be filed, which could take six months to process.

The Commission brought an action against Belgium before the ECJ because it considered the national legislation on the withholding obligation and joint liability to be incompatible with the freedom to provide services.

The Court acknowledged that the measure at issue did not discriminate, since it applied without distinction to residents and non-residents. Consequently, the ECJ applied a restriction-analysis. The Court held that the fact that the principal was required to withhold 15% of the price charged effectively deprived the service provider of the ability to have at his disposal a part of his income, which he could recover only at the conclusion of a specific administrative procedure. According to the Court, the disadvantages caused by the withholding obligation for non-resident service providers who are not registered in Belgium were liable to deter them from accessing the Belgian market in order to provide services in the construction sector. Similarly, the joint liability for all of the contractor's tax debts was liable to deter a resident principal from having recourse to the services of a non-resident contractor who was not registered in Belgium, yet who lawfully provides identical services in his Member State of establishment.

According to the Court, *"even if joint liability applies without distinction when an unregistered service provider is used, regardless of whether he is established in Belgium or in another Member State, it must nevertheless be stated that, while it does not deprive service providers who are not registered and not established in Belgium of the ability to supply their services there, the disputed provision does make access to the Belgian market difficult for them"*[1243].

Consequently, even though the measure applied without distinction to Belgian contractors and contractors established in another Member State, the Court held it to be incompatible with EU law. As in *Futura*, the requirement of registration was a purely procedural issue. And as in *Futura*, the question therefore arose whether the interest which the Belgian measure sought to protect could be sufficiently ensured by similar rules applicable in the contractor's home State. More specifically, the registration in Belgium implied compliance with a number of conditions, such as being registered with the social security administration, not having filed for bankruptcy, not having overdue debts for tax or social security purposes, having sufficient financial, administrative and technical resources to guarantee compliance with tax and social security obligations, etc[1244]. All those requirements are intended to ensure that the contractor is able to pay the tax due in Belgium as regards the construction work carried out there[1245]. That was the ultimate purpose of the registration: making sure that the contractor would pay the tax due in Belgium. And if the contractor was not registered, regardless of whether he was established in Belgium or not, there was a risk that he would not (be able to) pay the tax due in Belgium. In such a case, the withholding obligation and joint liability for the principal sought to ensure the payment of the tax due.

[1243] C-433/04, *Commission v Belgium*, § 28-31.
[1244] Art. 2 Royal Decree of 26 December 1998, *Official Gazette* 31 December 1998 and Comm. ITC No. 401/9.
[1245] See e.g. Opinion of Advocate-General Tizzano in C-433/04, *Commission v Belgium*, § 33, where the Belgian government points out that *"it is necessary to encourage the provision of services by registered operators, which […] offer sounder guarantees as regards compliance with tax and social-security obligations."*

Thus, by deciding that the obligation to register in Belgium constitutes a non-discriminatory restriction, the ECJ suggests that the purpose of the registration could, in theory, be sufficiently ensured by similar legislation in force in the contractor's home State. Indeed, it is possible that the contractor is subject in his home State to similar requirements which are also intended to ensure fulfilment of the contractor's tax obligations. Accordingly, the double burden imposed on contractors who provided services both in their home State and in Belgium resulted in a non-discriminatory restriction[1246].

> As it did in *Futura*, the Court nevertheless ultimately held that there were less restrictive measures available to achieve that purpose. As regards the withholding obligation, a less restrictive measure would have been to put in place a system, based on an exchange of information allowing, for example, principals to find out about any tax debts of their contracting partners or introducing an obligation to inform the Belgian tax authorities of any contract concluded with unregistered contracting partners or any payment made to them. As regards joint liability, a less restrictive measure would have been to allow the service providers to prove the compliant status of their tax situation or to allow principals and contractors to avoid joint liability by taking certain steps in order to satisfy themselves as to the tax-compliant status of the service providers with whom they wished to contract[1247].

That being said, it should be pointed out that the Belgian measure could also be seen as constituting indirect discrimination. Indeed, non-registered contractors will, in the vast majority of cases, be non-residents who only provide services in Belgium occasionally. Conversely, the vast majority of registered contractors will be residents, since registration is necessary to provide their services in Belgium without the principal being subject to the joint liability and the withholding obligation. As pointed out above, it is settled case-law that the Treaty freedoms prohibit not only direct discrimination on the basis of nationality, but also indirect discrimination which, although based on criteria which appear to be neutral, in practice leads to the same result[1248]. In the present case, it is clear that the less favourable tax treatment of non-registered contractors will generally be to the detriment of non-resident contractors. The Opinion of the Advocate-General also supports this approach[1249].

Therefore, it might have been more appropriate to apply a discrimination-analysis to the case at hand. Even though the issue was of a procedural nature, and therefore suitable for a

---

[1246] The Court does not address this point expressly, but seems to consider it tacitly: *"By the same token, [the joint liability] […] is liable to deter that principal […] from having recourse to the services of a provider who is not registered and not established in Belgium,* ***yet who lawfully provides identical services in his Member State of establishment****. Even if joint liability applies without distinction when an unregistered service provider is used, regardless of whether he is established in Belgium or in another Member State, it must nevertheless be stated that, while it does not deprive service providers who are not registered and not established in Belgium of the ability to supply their services there, the disputed provision does make access to the Belgian market difficult for them"* (C-433/04, *Commission v Belgium*, § 31, emphasis added).

[1247] C-433/04, *Commission v Belgium*, § 39-40.

[1248] See supra, 1.B.II and 2.D.I.

[1249] Opinion of Advocate-General Tizzano in C-433/04, *Commission v Belgium*, § 36: *"it cannot be ruled out […] that, although the rules at issue appear to apply without discrimination, they are in fact discriminatory. In point of fact, as I noted earlier, the measures at issue apply solely to operators not registered in Belgium. If that is the case, however, it must be concluded […] that a criterion of that nature is of itself capable of giving rise to disparity of treatment between operators on the basis of their country of establishment or citizenship. Unregistered operators will, in effect, be (almost) exclusively foreign operators, and, in particular, those wishing to provide services in Belgium only on an occasional basis, whereas national operators will be (almost) always registered as contractors as they have to meet that requirement specifically in order to be able to pursue their activities in Belgium."*

restriction-analysis, the need for legal certainty and consistency of case law requires that all cases involving discrimination are assessed on the basis of the same discrimination-test. Put differently, issues of substantive tax law are unsuited for a restriction-analysis and can therefore only come within the scope of the Treaty freedoms if the national legislation at issue distinguishes on the basis of a prohibited criterion (see supra). Issues of procedural tax law can be addressed both from the perspective of discrimination and restriction, but if the national rules at issue distinguish on the basis of a prohibited criterion, it is more appropriate to apply a discrimination-analysis.

e. Conclusion

1. Procedural versus substantive tax law

Put briefly, the distinction between procedural and substantive direct tax law could function as a *Keck*-like distinction: truly restrictive procedural tax measures may fall within the scope of the Treaty freedoms, but substantive tax rules that apply without any distinction go beyond this scope. In order for substantive direct tax rules to fall within the scope of the Treaty freedoms, they must distinguish on the basis of a prohibited criterion[1250]. Obviously, that does not mean that cases involving procedural tax law should always be considered from the perspective of a restriction-analysis. Indeed, when a national procedural tax rule makes a distinction that constitutes direct or indirect discrimination, it is appropriate to apply the discrimination-test instead of the restriction-test.

But a mere distinction between procedural and substantive tax law is not sufficiently specific. The actual distinction is between measures which protect an interest than can be sufficiently ensured by similar rules applicable in the other Member States and measures where that is not the case. As pointed out above, measures of substantive tax law seek to ensure interests that are proper to the Member State that enacted the rule and those interests can therefore not be ensured by similar measures of another Member State. In contrast, **some** procedural measures seek to protect interest that are already sufficiently protected by the measures applicable in another Member State.

For that reason, the Court has accepted that the mere existence of a double burden in procedural tax matters gives rise to a restriction. When subsequently verifying whether that restriction is justified, the Court determines whether the objective pursued by the domestic measure that gives rise to the double burden can already be achieved by the legislation of another Member State. For instance, in *Futura*, the obligation to keep separate accounts sought to protect Luxembourg's interest to be able to ascertain the amount of losses connected with the PE. Given the absence of harmonization in this field, that interest was not necessarily protected by the obligation to keep accounts in France (the taxpayer's home State). On the other hand, it was possible to allow the taxpayer to demonstrate the amount of losses and the Luxembourg tax authorities could request relevant information from France under the Mutual

[1250] It should be noted that the Court's case law on the free movement of goods has evolved in the past decade, prompting certain authors to question whether *Keck* has now been overruled (see e.g. E. SPAVENTA, "Leaving Keck behind? The free movement of goods after the rulings in Commission v Italy and Mickelsson and Roos", *E. L. Rev.* 2009, 34(6), 914-932). Moreover, the *Keck*-distinction as such has often been criticized in literature (see supra). However, that evolution and those criticisms do not affect the analysis made here. Given the specific nature of the Court's case law in direct tax matters, the positions developed in the case law on the free movement of goods cannot simply be transposed to cases involving direct taxation. Moreover, the analogy drawn here, that the distinction between procedural and substantive direct tax law could function as a *Keck*-like distinction, is merely illustrative, in that it serves to clarify the dichotomy in the Court's case law on direct taxation. It does not imply that that case law evolves in the same direction as the case law on the free movement of goods.

Assistance Directive. The approach in *Commission v Belgium* could be seen as slightly different since in that case, the Court seems to consider the effect of the home State legislation already when determining whether a restriction existed. In that case, the registration in Belgium implied compliance with a number of conditions, all of which were intended to ensure that the contractor was able to pay the tax due in Belgium as regards the construction work carried out there. In deciding that the double burden imposed by the Belgian requirement was restrictive, the Court seems to take account of the fact that the objective pursued could in theory already be ensured by similar obligations in force in the contractor's home State[1251]. Ultimately, however, the result was the same as in *Futura*: because there were less restrictive means available to achieve the objective in question, the double burden was not justified.

2. The existence of a disadvantage

As a sidenote, it should be observed that it is implicit in the definition of restrictions as 'measures applicable without distinction that are liable to hinder the free movement or make it less attractive', that the term 'distinction' refers to a disadvantageous distinction. The qualification that measures constituting restrictions must apply 'without distinction' serves to distinguish this category of measures from discriminatory measures (i.e. measures that apply 'with distinction'). And as mentioned earlier, the distinction created by discriminatory measures must be a disadvantageous distinction. Consequently, when defining the concept 'restriction' as the opposite of the concept 'discrimination' with respect to the existence of a distinction, it is obvious that the 'distinction' in the definition of 'restriction' also refers to disadvantageous distinctions.

The importance of this nuance is the following. Assume that a Member State imposes a tax obligation both on domestic activities and on cross-border activities, but the obligation imposed on the cross-border activities is more favourable. This difference in treatment obviously does not constitute discrimination, as the cross-border situation is favoured as compared to the domestic situation. On the other hand, it could be suggested that there is no restriction either, since there is a distinction between domestic situations and cross-border situations. However, the measure is clearly restrictive: suppose that the PE State in *Futura* (i.e. Luxembourg) imposed a certain set of accounting rules on cross-border activities and another, stricter set of accounting rules on domestic activities. Even though the measure would apply 'with a distinction', the double burden resulting from the combination of the home State rules and the PE State rules would result in the same restriction as the one struck down in *Futura*. Accordingly, the requirement that restrictions must apply without distinction actually means that they must apply without distinction **to the detriment** of the cross-border situation. Measures that distinguish in favour of cross-border situations may still be restrictive.

3. Importance of the distinction

In substantive tax matters, actual applications of a pure restriction-based approach are very rare, if not non-existent. *Sandoz* and *De Coster* are sometimes mentioned in this regard, but as

[1251] C-433/04, *Commission v Belgium*, § 31: *"the fact that […] the principal who contracts with a service provider not registered in Belgium is made jointly liable for all of that provider's tax debts relating to earlier taxable periods at the rate of 35% of the price of the work to be carried out is liable to deter that principal or contractor from having recourse to the services of a provider who is not registered and not established in Belgium,* ***yet who lawfully provides identical services in his Member State of establishment****"* (emphasis added).

observed earlier, *Sandoz* should have been decided as a disparity-case and *De Coster* was clearly based on a discrimination-analysis.

Moreover, some cases seem to suggest a shift towards a restriction-based readings, but the 'restriction' which they describe is merely a consequence of an obvious discrimination. In *Avoir fiscal*, for instance, the Commission argued that the measure at issue was **both** discriminatory and restrictive. As will become apparent below, however, the 'restriction' was merely a consequence of the discriminatory nature of the measure at issue (see 2.E.I.A.a.1.a). The ECJ did not apply this distinction: there is no distinction between the discrimination-approach and the restriction-approach in the Court's reasoning in *Avoir fiscal*. Rather, the restriction is merely the effect of the discrimination on the freedom. In other words, it is the **discrimination** that is prohibited, and the **reason** why it is prohibited, is that it constitutes a **restriction** to the freedom (see *Avoir fiscal*, § 14: *"[Art. 52 EC] prohibits, as a restriction on the freedom of establishment, any discrimination on grounds of nationality"* and § 27: *"that discrimination constitutes a restriction"*). However, the ECJ is not always consistent in this respect. In *CLT-UFA*, for instance, the Court referred to a clearly discriminatory measure as a 'restriction, even though it would have been more precise to say that the discrimination caused a restriction to the relevant freedom (see 2.E.I.A.a.1.f).

Finally, it could be argued that important elements of the Court's body of case law in direct taxation are fundamentally irreconcilable with a pure restriction-based reading of the Treaty freedoms. For instance, the *Schumacker*-line of case law, which still stands today (see 2.E.I.A.b.1), could be abandoned if a pure restriction-based reading were accepted. Even though there is an obvious restriction to the free movement in *Schumacker*-type situations, the Court still applies the discrimination-analysis – including the comparability-test – which makes it impossible in most cases to resolve the issue. If the Court's case law had evolved towards a pure restriction-based interpretation, there would be no comparability-issues, as there would be no need to resort to the discrimination-analysis.

The interpretation set out here does not seek to suggest an extension or reduction of the traditionally accepted scope of application of the fundamental freedoms. What it comes down to is that the ECJ has expressly recognized that the freedoms have an additional dimension, apart from the strict idea of discrimination on the basis of nationality. But it would be incorrect to describe that case law as 'restriction' based. Indeed, that case law is firmly based on the idea of discrimination, albeit discrimination on the grounds of the exercise of a Treaty freedom. In other words, the interpretation set out above solely amounts to an analysis and classification of the Court's case law, in a way that seeks to reconcile its different tendencies. Accordingly, it is all a matter of nomenclature, but nevertheless a matter of significant importance. In particular, the characterization of these cases as discrimination-cases implies that the traditional decision tree of the Court's discrimination analysis should be applied, including the comparability-test.

V.D. Restriction and discrimination are complementary components of the freedoms

Apart from the fact that many restriction-based cases are actually disguised discrimination cases, it is clear that restriction does not replace discrimination, but rather complements it. In the Court's recent case law, both concepts cooperate, depending on the type of national legislation being tested. However, the ECJ is not always precise in distinguishing between both concepts. Perhaps these inconsistencies may be explained by the unclarity of the wording used in the Treaty as regards the scope of application of the different freedoms[1252]. Another proposed explanation is that there remains some confusion on the level of justification[1253]. In particular, it appears that the ECJ is still influenced by the idea that discriminatory measures can only be justified on the basis of grounds explicitly mentioned in the treaty, whereas restrictive measures can also be justified under the rule of reason. Indeed, the Court has never formally abandoned this dichotomy and still applies it every so often. In *Royal Bank of Scotland*, for instance, the Court refused to examine grounds of justification not expressly mentioned in the Treaty as regards a directly discriminatory measure[1254]. Similarly, in *Ciola*, the Court refused to consider the rule of reason-defense for a measure which was *indirectly* discriminatory[1255].

On the other hand, in many cases dealing with national measures which might have been considered (directly) discriminatory, the Court has avoided examining whether the measures were in fact discriminatory, and has examined grounds of justification not expressly mentioned in the treaty. In such cases, the Court side-steps the issue by calling the measure an 'obstacle' to the freedom at issue[1256] or referring to a 'difference in treatment'[1257], and then testing rule of reason-defenses.

It is not very realistic to cling to this strict dichotomy[1258]. Instead, it is preferable to opt for clarity and legal certainty, and clearly state that both restrictive and discriminatory measures may fall under the rule of reason. The most eloquent argument in favour of this approach has perhaps been made by Advocate-General Jacobs, who has observed that *"it is inappropriate to have different grounds depending upon whether the measure is discriminatory (directly or indirectly) or whether it involves a non-discriminatory restriction on the provision of services. Once it is accepted that justifications other than those set out in the Treaty may be invoked, there seems no reason to apply one category of justification to discriminatory measures and another category to non-discriminatory restrictions. Certainly the text of the Treaty provides no reason to do so […]. In any event, it is difficult to apply rigorously the distinction between (directly or indirectly) discriminatory and non-discriminatory measures. Moreover, there are general interest aims not expressly provided for in the Treaty (e.g. protection of the*

1252 For instance, Art. 45 TFEU (on the free movement of workers), expressly refers to *"the abolition of any discrimination based on nationality between workers of the Member States"*, whereas no such reference to discrimination is made in the other freedoms. Cf. Art. 49 (on the freedom of establishment), Art. 56 (on the freedom to provide services) and Art. 63 (on the free movement of capital) which refer to the prohibition of **restrictions** on the relevant freedom. It should be added, however, that both the freedom of establishment and the freedom to provide services also refer to *"the same conditions as imposed by [the other Member State] on its nationals"*, which is a clear reference to nationality discrimination. Moreover, in case the different wording of the different freedoms would serve to explain the inconsistent case law, then the fault line between the different interpretations could be drawn along the lines of the different freedoms. However, the division is not that clear-cut. The inconsistencies are present in each body of case law, regardless of the applicable freedom.

1253 A. CORDEWENER, "The prohibitions of discrimination and restriction within the framework of the fully integrated internal market", in F. VANISTENDAEL (ed.), *EU Freedoms and direct taxation*, Amsterdam, IBFD Publications, 2006, 3.

1254 C-311/97, *Royal Bank of Scotland*, § 32.

1255 C-224/97, *Erich Ciola v Land Vorarlberg*, § 16.

1256 E.g. C-118/96, *Safir*, § 25.

1257 E.g. C-55/98, *Vestergaard*, § 22 and C-294/97, *Eurowings*, § 36. Similarly: C-204/90, *Bachmann*, § 9.

1258 Cf. for instance C-484/93, *Svensson and Gustavsson*, in which the Court first held that the national measure *"constitute[d] discrimination against credit institutions established in other Member States"* (§ 12), and that *"such discrimination can only be justified on the general interest grounds referred to in Article [46(1)] of the Treaty, to which Article [55] refers"* (§ 15). However, the Court then went on to examine the fiscal cohesion-argument.

environment, consumer protection) which may in given circumstances be no less legitimate and no less powerful than those mentioned in the Treaty"[1259].

That being said, it is clear that restriction does not replace discrimination, but complements it. From this point of view, each fundamental freedom encompasses both a non-discrimination component and a non-restriction component, both of which play a role in the realization of an Internal Market[1260]. Nevertheless, it should be repeated that the concept of restriction is of relatively little importance in direct taxation. As discussed above, the particular nature of direct taxation makes it impossible to transpose the restriction-approach to cases concerning substantive tax matters. As regards procedural tax law, however, the concept of restriction may play an important role in the realization of the internal market. In particular, where national procedural measures truly apply without any distinction on the basis of a prohibited criterion (e.g. *Futura*), the concept of non-discrimination is insufficient. In such cases, the restriction-component of the fundamental freedoms comes into play.

V.E. Conclusion

Several conclusions can be drawn from this analysis. First, the ECJ is inconsistent on the level of language as regards the distinction between the concepts of discrimination and restriction. Several national measures that were clearly discriminatory have been referred to by the Court as being 'restrictive'. Certain commentators have tried to make sense of these inconsistensies by distinguishing between different types of restrictions, for instance between 'restrictions in an economic sense' and 'restrictions in a legal sense'[1261], or between 'quasi-restrictions' and 'true restrictions'[1262]. Unfortunately, these additional distinctions add to the confusion. In my opinion, the basic distinction between discrimination and restriction is sufficient, it being understood that 'restriction' is defined 'a measure that applies without any distinction to the detriment of a protected category of taxpayers'. As such, a restriction is the exact opposite of a discrimination on the level of the existence of a distinction. In all other respects, these concepts are identical (that is to say, with regard to the existence of a disadvantage and the possibility to justify the national measures at issue). Generally, direct tax measures that apply without any distinction fall outside the scope of the free movement provisions. As discussed above, substantive tax rules that apply without any distinction may cause obstacles to the free movement, but these obstacles are the result of disparities. In contrast, certain measures of a procedural nature that apply without any distinction, such as the measure at issue in *Futura*, may be considered to be in breach of the Treaty.

[1259] Opinion of Advocate-General Jacobs in C-136/00, *Danner*, § 40.
[1260] A. CORDEWENER, *o.c.*, 9; F. VANISTENDAEL, "A comparative and economic approach to equality in European Taxation", in R. GOCKE, D. GOSCH and M. LANG (eds.), *Körperschaftsteuer, internationales Steuerrecht, Doppelbesteuerung. Festschrift für Franz Wassermeyer*, Munich, Verlag C.H. Beck, 2005, 533.
[1261] A. ZALASINSKI, "The limits of the EC concept of 'direct tax restriction on free movement rights', the principle of equality and ability to pay, and the interstate fiscal equity", *Intertax* 2009, 288-289.
[1262] See Advocate-General Geelhoed's Opinion in C- 374/04, *Test Claimants in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue*, 23 February 2006, *ECR* 2006, I-11673, § 31 *et seq*. 'Quasi-restrictions' are distortions of economic activity resulting from the co-existence of the different legal systems. Given the causes and nature of these quasi-restrictions, they may only be eliminated by the European legislator, by implementing an EU-wide tax system. In the absence thereof, they fall outside the scope of EU law. In contrast, 'true restrictions' go beyond the inevitable consequences from the co-existence of national tax systems as they are caused by the rules of one jurisdiction. These measures do fall within the scope of the fundamental freedoms.

Moreover, the evolution in the Court's non-tax case law towards a restriction-based reading of the Treaty cannot easily be transposed to direct taxation. Starting with *Futura*, the ECJ has tried to adopt such a restriction-approach, but the particular nature of direct taxation has severely limited the success of these attempts. It is difficult to reconcile this idea with the position that the Treaty freedoms should be interpreted uniformly in all areas of law[1263], but the reality of case law shows that such a uniform interpretation is currently an illusion[1264]. More specifically, an actual application of the restriction-approach to substantive direct tax measures would mean that almost every element of national tax legislation would constitute a *prima facie* violation of the Treaty: the mere fact that an activity or an economic agent is taxed, or the mere fact that the tax systems of the Member States differ, is liable to make an activity less attractive or to dissuade economic agents from exercising their Treaty freedoms. Such an approach is untenable in direct taxation, given the Member States' sovereignty in this field and the fact that disparities fall outside the scope of the Treaty freedoms.

Finally, the category of 'protected taxpayers' should not be limited to nationals of a Member State as compared to nationals of another Member State[1265]. The EU Treaties also protect the exercise of the Treaty freedoms, which implies that taxpayers exercising their Treaty freedoms should be protected from discrimination as compared to taxpayers not exercising those freedoms. National measures that distinguish on that basis are discriminatory, rather than restrictive.

E. Case law

I. Discrimination

The discussion of the Court's case law will be structured along the lines of the ECJ's traditional discrimination-analysis. Accordingly, a first section will deal with the comparability-test while a second section concerns the disadvantage-test. The former section is dividend in two main subsections. The first subsection concerns the determination of the subject and object of comparison, the second subsection concerns the determination of the relevant characteristics. In the section concerning the disadvantage-test, the Court's understanding of the concept 'disadvantage' is first addressed, then it is examined whether offsetting advantages may remove a disadvantage and finally the issue of identical treatment of incomparable situations is examined. The third section deals with the equal treatment of incomparable situations.

Some preliminary remarks are in order before starting the analysis. First, only case law concerning primary EU law will be addressed, cases dealing with the application of secondary EU law will not be considered. Consequently, only cases in which the ECJ applies the Treaty freedoms to direct tax measures will be analysed. Issues relating to the application of Directives, such as the Parent-Subsidiary Directive, and other instruments of secondary EU law will be left out of the analysis.

[1263] E.g. Case 82/71, *Italy v Società agricola industria latte (SAIL)*, 21 March 1972, § 5: *"the effectiveness of Community law cannot vary according to the various branches of national law which it may affect."*
[1264] See also J. SNELL, "Non-discriminatory tax obstacles in Community law", *International & Comparative Law Quarterly* 2007, 56(2), 340-348, who notices the same phenomenon in the Court's indirect tax case law.
[1265] Including other criteria that are derived from the nationality-criterion (such as residence) and may therefore lead to indirect discrimination.

Secondly, given the convergence of the Court's case law, it will be assumed that the analysis under the four fundamental freedoms is the same[1266]. Accordingly, the analysis starts from the assumption that the comparability-test, the disadvantage-test and the justification-test is identical under all freedoms. This implies that little attention will be given to the question as to which freedom applies to a given case.

Finally, the purpose of this analysis is to identify a common principle of non-discrimination, underlying the Court's case law on direct taxation. It does not seek to give an exhaustive overview of possible inconsistencies or contradictions in the Court's case law. Instead, the principal aim of this study is to reconcile the different ideas emerging from the case law, thereby trying to demonstrate that certain decisions which seem contradictory at first sight, are actually the inevitable result of the Court's application of the non-discrimination principle. For that reason, the selection of case law discussed here is by no means exhaustive. The cases that will be analysed illustrate the Court's decision process in a given area (e.g. the taxation of inbound PEs), so as to identify common, underlying principles and, ultimately, allow for a comparison with the non-discrimination standard of Art. 24 OECD MC.

I.A. Comparability

a. Constructing the comparison I: how to determine the subject and object of comparison?

As mentioned before, any discrimination-test is an inquiry into comparability. Accordingly, the very core of a discrimination-test is the comparison of two groups or situations, which consists of identifying the relevant characteristics and then determining whether those characteristics are identical. I refer to these two groups or situations as the subject of comparison and the object of comparison (cf. Part I.B). It is therefore essential to start a discrimination-test by identifying the proper subject and object of comparison. Through a discussion of the ECJ's case law, I will examine which elements the Court takes into account when making this analysis. As mentioned in Part I.B, the subject and object of comparison are always each other's mirror image as regards the comparative attribute. Given this interrelated nature, I will address the role of subject and object of comparison in the ECJ's case law together.

1. The taxation of inbound permanent establishments

The starting point of this analysis is the taxation of PEs of companies established in another Member State. These cases deal with PEs of non-resident companies who are denied tax concessions available to residents. The subject of comparison in these cases is the PE of the non-resident company, while the object of comparison is a resident company. This allows us to draw a clear comparison to the analysis made earlier, with respect to Article 24(3) OECD MC. As mentioned in Part II, 2.D, the comparison under Article 24(3) OECD MC is made between 'the PE which an enterprise of a Contracting State has in the other Contracting State' and 'enterprises of that other Contracting State carrying on the same activities'.

These cases are an excellent starting point for an analysis of the ECJ's understanding of comparability, as they are controlled entirely by the comparative attribute, and the different values thereof as regards the subject and object of comparison. More specifically, the subject of comparison is a non-resident company having a PE in another State, the object of

[1266] With a possible exception as regards the free movement of capital in relation to third countries: see 2.E.I.A.b.8.b.

comparison is a resident company of that State and the comparative attribute is the taxpayer's (non-)residence in the Member State concerned.

a. Avoir fiscal[1267]

Avoir fiscal was the first case in which the ECJ applied the fundamental freedoms to tax provisions[1268], which might explain why the Court's reasoning is set out quite carefully (even though the judgment consists of just 29 paragraphs). At issue was French tax legislation which denied shareholder credits to PEs[1269] of non-resident companies.

French tax law at the time provided for the charge of corporation tax at a rate of 50% on all profits made by companies. That tax was the equivalent of the income tax to which individuals were liable. In order to reduce the effects of the cumulative taxation of profits distributed by companies (i.e. first corporate tax in the hands of the company distributing dividends and then income tax in the hands of the recipient), the French legislation provided for a tax credit, the so-called 'avoir fiscal'. The credit was granted to recipients of dividends distributed by French companies and was equal to half the amount paid by those companies. The credit could be set off against the tax payable by the recipient.

The tax credit was only granted to French residents[1270]. Consequently, the tax credit was not available in respect of shares forming part of the assets of PEs of non-resident companies. As a result, there was a difference in treatment between, on the one hand, companies resident in France (including French subsidiaries of non-resident companies) who could benefit from the 'avoir fiscal' and, on the other hand, PEs in France of non-resident companies who could not benefit from that advantage.

The Commission brought forward two arguments to establish that the French legislation violated the freedom of establishment. First, the rules discriminated against PEs in France of non-resident companies as compared to resident companies. According to the Commission, the French tax system prevented such PEs *"from holding French shares and thus places them at a disadvantage in the pursuit of their activities in France."* Furthermore, *"the discrimination is made all the more clear by the fact that, for the purpose of determining*

[1267] C-270/83, *Commission v France (Avoir fiscal)*, 28 January 1986.

[1268] Although the case is generally recognized as the starting point of the Court's acitivities in direct tax matters, it should be borne in mind that the ECJ had already made forays into the Member States' competence in direct tax matters (albeit not on the basis of the fundamental freedoms). The very first case in which the ECJ decided on an issue involving Member States' direct tax competence seems to be 6/60, *Humblet v Belgian State*, 16 December 1960. The case was decided on the basis of the ECSC Treaty, more specifically the Priviliges and Immunities Protocol which exempted the salary of ECSC officials from all taxes. The question arose whether the Belgian 'exemption with progression' fell foul of this requirement. According to the Court, the Belgian regime constituted indirect taxation of Community salaries. Consequently, *"a Member State infringes the Protocol if it takes account of the salaries paid by the Community to its officials in order to determine the rate of tax due on other income which is not exempted where the national tax law provides for a system of taxation on a rising scale"* (*Humblet*, § 5). The *Humblet*-case can therefore be seen as a very early warning signal to the Member States that the ECJ did not consider direct tax matters to fall entirely beyond its grasp.

[1269] For the sake of clarity, I will use the term 'permanent establishment' throughout my analysis of this case law, instead of the expression 'secondary establishments, branches and agencies' which is used by the Court. The Court's reasoning and the outcome of the case were not affected by the distinction between these different terms.

[1270] There was an exception for certain residents of tax treaty partners, but this exception is irrelevant to the present discussion.

taxable income, French tax law applies the same rules to French companies as it does to [permanent establishments] of foreign companies"[1271].

Secondly, the Commission argued that the fact that the tax rules in question were unfavourable to the PEs of non-resident companies *"indirectly restricts the freedom which [non-resident companies] must have to establish themselves in France either through a subsidiary or through a [permanent establishment]. It constitutes an inducement to choose to set up a subsidiary so as to avoid the disadvantage resulting from the refusal to grant the benefit of the shareholders' tax credit"*[1272].

Thus, the Commission seems to take a two-tier approach, by arguing, first, that the French rules are discriminatory and, secondly, that the rules are restrictive[1273]. It is clear, however, that the second argument is actually an aspect of the first: the discrimination which is challenged in the first argument, is the reason for the alleged 'restriction' described in the second argument. For that reason, the Court does not follow the strict division of the Commission. The Court first observes that the freedom of establishment is one of the fundamental principles of the EU and that it is intended to ensure *"that all nationals of Member States who establish themselves in another Member State, even if that establishment is only secondary, for the purpose of pursuing activities there as a self-employed person receive the same treatment as nationals of that State and it prohibits, as a restriction on freedom of establishment, any discrimination on grounds of nationality resulting from the legislation of the Member State"*[1274].

The Court thus draws the link between discrimination and restriction, observing that any discrimination on grounds of nationality falls foul of Art. 49 TFEU, as it constitutes a restriction to the fundamental freedom embodied by that provision. The Court points out that the freedom of establishment intends to ensure that nationals of a Member State who establish themselves in another Member State *"receive the same treatment as nationals of that State."* As a result of this national treatment-requirement, any discrimination on grounds of nationality is prohibited. The Court thus firmly anchors its analysis in a discrimination-based reading of the provision. The 'restriction' of the freedom of establishment, to which Article 49(1) refers, consists precisely of this discriminatory treatment. Accordingly, there is no distinction between the discrimination-approach and the restriction-approach in the Court's reasoning. Rather, the restriction is merely the result of the discrimination on the freedom. In other words, it is the **discrimination** that is prohibited, and the **reason** why it is prohibited, is that it constitutes a **restriction** to the freedom of establishment[1275].

[1271] C-270/83, *Avoir fiscal*, § 11.
[1272] C-270/83, *Avoir fiscal*, § 11.
[1273] On the distinction between discrimination and restriction, cf. supra, 2.D.V.
[1274] C-270/83, *Avoir fiscal*, § 14.
[1275] The Advocate-General held a different opinion. According to A.-G. Mancini, *"discrimination and restrictions on establishment are different phenomena and it does not necessarily follow that a measure likely to give rise to the one will also contribute to the other. Thus, the discouragement of agencies and branches may be an aspect of the discriminatory treatment of foreign companies but does not affect their right to establish themselves in France. According to Article [43], that right includes the abolition of restrictions on the 'setting up of agencies, branches or subsidiaries'. In my opinion, those words cannot be interpreted as meaning that the three forms of secondary establishment must be subject to absolutely identical rules whether in regard to taxation or to anything else"* (Opinion of Advocate-General Mancini, 16 October 1985, *ECR* 1986, 273, § 11). This reasoning is odd. Discriminatory tax treatment is precisely the most obvious type of restriction to the freedom of establishment, so it is not entirely clear why the Advocate-General argued that *'the discouragement of agencies and branches [as] an aspect of the discriminatory treatment of foreign companies […] does not affect their right to establish themselves in France."* Cf. also supra, 2.D.V.A.

On the basis of this reasoning, the Court concludes that *"it thus appears that the two submissions put forward by the Commission, namely that concerning discrimination […] and that concerning the restriction of the freedom [of establishment], are closely linked. They must therefore be considered together"*[1276].

In defense of its tax system, the French government argued that the different treatment did not give rise to discrimination because the situations were incomparable. In particular, the French government argued that the difference in question was based on the distinction between residents and non-residents, *"which is to be found in all legal systems and is internationally accepted [and] is an essential distinction in tax law"*[1277] [1278]. In this respect, the Court first stressed that the freedom of establishment includes the right of companies established within the EU to pursue their activities in another Member State through a PE. Furthermore, the ECJ noted that, with regard to companies, the registered office serves as the connecting factor with the legal system of a particular State, like nationality in the case of natural persons. Accordingly, the freedom of establishment would be rendered meaningless if a Member State could freely apply different treatment to companies solely by reason of the fact that its registered office is situated in another Member State[1279].

The Court then addresses the core issue: the comparability of the situations. The ECJ starts by pointing out that *"even if the possibility cannot altogether be excluded that a distinction based on the location of the registered office of a company or the place of residence of a natural person may, under certain conditions, be justified in an area such as tax law, it must be observed in this case that French tax law does not distinguish, for the purpose of determining the income liable to corporation tax, between companies having their registered office in France and branches and agencies situated in France of companies whose registered office is abroad. […] Both are liable to taxation on profits made in undertakings carried on in France, to the exclusion of profits which are made abroad or which France is entitled to tax under the terms of a double-taxation agreement"*[1280].

From this observation, the ECJ infers that there is no objective difference between both situations: *"since the rules at issue place companies whose registered office is in France and branches and agencies situated in France of companies whose registered office is abroad on the same footing for the purposes of taxing their profits, those rules cannot, without giving rise to discrimination, treat them differently in regard to the grant of an advantage related to taxation, such as shareholders' tax credits. By treating the two forms of establishment in the*

[1276] C-270/83, *Avoir fiscal*, § 15.
[1277] This argument is further elucidated in the Advocate-General's opinion. There, the position of the French government is set out as follows: *"[The French government] contended that the legal form which an undertaking gave to its subordinate structures was not without consequences from the point of view of taxation since it could affect the forms of taxation to which such structures were liable. Thus, a subsidiary of a foreign undertaking was a legal person and, in so far as it was subject to French law, was regarded as 'resident' for the purposes of taxation. On the other hand, branches and agencies were secondary establishments of the undertaking and were not autonomous. For the purposes of taxation therefore they were regarded as being 'non-resident' in the State in which they operated"* (Opinion of Advocate-General Mancini, 16 October 1985, *ECR* 1986, 273, § 3).
[1278] C-270/83, *Avoir fiscal*, § 17. In the same paragraph, the French government advanced two other arguments, which actually relate to the disadvantage-test rather than the comparability-test (i.e. the existence of offsetting advantages and the minor character of the disadvantage). Given their place in the discrimination-analysis, these arguments will be discussed in 2.E.I.B.
[1279] C-270/83, *Avoir fiscal*, § 18.
[1280] C-270/83, *Avoir fiscal*, § 19.

same way for the purposes of taxing their profits, the French legislature has in fact admitted that there is no objective difference between their positions in regard to the detailed rules and conditions relating to that taxation which could justify[1281] *different treatment"*[1282].

The ECJ thus recognizes that the place of residence[1283], the comparative attribute *in casu*, could be a relevant difference in some cases, but not in this one. The French tax law did not distinguish between resident and non-resident companies as regards their tax liability: both were subject to tax on the same taxable basis. According to the ECJ, *"by treating the two forms of establishment in the same way for the purposes of taxing their profits, the French legislature has in fact admitted that there is no objective difference between their positions in regard to the detailed rules and conditions relating to that taxation."* This reasoning might seem odd at first glance. Indeed, the comparability of two situations in a given context should not depend on them being labelled comparable in another context, or by 'admitting' that they are, in fact, comparable. On the other hand, one could argue that the identical treatment of both situations as regards the determination of tax liability **renders** them comparable as regards the tax credit. In other words, it is not really a matter of the French legislature admitting that residents and non-residents were comparable all along, but rather the equal treatment of both categories at the level of tax liability rendering them comparable at the level of the tax credit.

From this reasoning, one could infer that equal treatment at the level of tax liability renders residents and non-residents comparable as regards the availability of tax credits[1284]. In the absence of such equal treatment at the tax liability-level, both categories may very well be incomparable. However, the validity of this argument may be debatable. Assuming that

[1281] It should be noted that the Court sometimes states that the incomparability of the situations 'justifies' a different treatment. However, it is clear that no justification is necessary if the situations are incomparable. Discrimination can only arise if comparable situations are treated differently (or, vice-versa, if different situations are treated identically). Consequently, if the situations cannot be compared, there is no discrimination, which means that there is nothing to justify. By suggesting that a relevant difference between two situations 'justifies' their different treatment, the Court confuses the first and the third step of the discrimination-analysis. Of course, every justification will serve precisely to justify a different treatment, which means that the justification relates differently to one situation than to the other. However, using this argument to conclude that the justification is simply a form of incomparability would be a post-hoc analysis (see also 2.F.III).

[1282] C-270/83, *Avoir fiscal*, § 20.

[1283] It is remarkable that the Court in § 19 refers to the location of the registered office of a company and the **place of residence** of an individual. As the Court had first equated the location of companies' registered office with the **nationality** of individuals (cf. C-270/83, *Avoir fiscal*, § 18 and supra), one would expect the same parallel to be drawn here. Perhaps the ECJ was reluctant to state that distinctions on the basis of the registered office of a company **or the nationality of individuals** might be justified (cf. supra, on the distinction between direct and indirect discrimination). Or perhaps the reference to 'the registered office of a company' and 'the place of residence of an individual' in § 19 can simply be explained by the fact that the French legislation only granted the tax credit to 'persons who have their habitual residence or registered office in France'. In any event, it is confusing that the Court first equates registered office and nationality and then places registered office and residence on the same footing. By contrast, the Advocate-General, in summarizing the Commission's position, consistently refers to discrimination on the basis of nationality: *"to treat [companies] differently by reason of the location of their registered office […] amounts to discrimination on the basis of their nationality."* Nevertheless, the Advocate-General then states that *"the discrimination is admittedly not explicit; in point of fact it is well hidden. However, as was stated in [C-152/73, Sotgiu], that does not prevent it being incompatible with the Treaty"* (Opinion of Advocate-General Mancini, 16 October 1985, *ECR* 1986, 273, § 10). As the French measure clearly distinguishes on the basis of the registered office, it is odd that the Advocate-General refers to the prohibition of indirect discrimination, illustrated by *Sotgiu*.

[1284] See also 2.E.I.A.b.6.c: the Court's position on outbound dividends is that residents and non-residents are comparable with respect to measures intended to alleviate double taxation if the source State imposes a tax both on domestic dividends and on outbound dividends.

resident companies were subject to tax in France on their worldwide income (i.e. unlimited tax liability) and non-resident companies only on their French-source income (i.e. limited tax liability), would this distinction have rendered them incomparable? The distinction between unlimited tax liability for residents and limited tax liability for non-residents is at the very heart of most tax systems[1285], so the conclusion that this distinction renders both categories incomparable would mean a severe limitation of the indirect discrimination-test in direct tax matters. As will become apparent below, however, the Court's reasoning is not that linear.

On the other hand, it could be argued that the tax liability is not as relevant as the **nature of income** at issue. If a dividend from French companies gives entitlement to a tax credit for French residents, there is no apparent reason to deny this credit for non-residents, at least not at the level of comparability[1286]. Distinctions between residents and non-residents as regards the tax credit could then possibly be justified at a later stage of the analysis, for instance by referring to the cohesion of the tax system.

b. Commerzbank[1287]

Commerzbank, a company incorporated under German law and having its registered office in Germany, had a PE in the U.K., through the intermediary of which it granted loans to a number of U.S. companies. Commerzbank paid tax in the U.K. on the interest received from those U.S. companies.

Subsequently Commerzbank sought repayment of that tax from the U.K. tax authorities on the ground that the interest was exempt in the U.K. by virtue of Article XV of the U.K./U.S. tax treaty. That Article provided in substance that interest paid by a U.S. company was taxable in the U.K. only when it was paid to a company resident for tax purposes in the U.K. Since Commerzbank was not a U.K. resident for tax purposes, it received a refund of the overpaid tax.

Commerzbank then claimed interest on this refund on the basis of a provision in the domestic U.K. tax legislation. According to that provision, refunds made by the tax administration to companies resident in the U.K. were increased by a 'repayment supplement'. The tax authorities refused Commerzbank's claim on the ground that the company was not resident in the U.K. During the subsequent judicial dispute, the question arose whether this limitation of the repayment supplement on refunds of overpaid tax violated the freedom of establishment.

The ECJ first referred to *Avoir fiscal* and reiterated that the freedom of establishment would be meaningless if Member States could freely apply different treatment to companies on the basis that their seat is located in another Member States. The Court also referred to *Sotgiu* and held that *"the rules regarding equality of treatment forbid not only overt discrimination by reason of nationality or, in the case of a company, its seat, but all covert forms of discrimination which, by the application of other criteria of differentiation, lead in fact to the same result"*[1288].

[1285] One might have read the French government's contention that the distinction between residents and non-residents *"is to be found in all legal systems and is internationally accepted [and] is an essential distinction in tax law"* (cf. supra) as implicitly referring to this distinction as regards tax liability, but – as mentioned – no such distinction was made in French tax law at the material time.
[1286] Compare this with C-311/97, *Royal Bank of Scotland*, discussed below.
[1287] C-330/91, *The Queen v Inland Revenue Commissioners, ex parte Commerzbank AG*, 13 July 1993.
[1288] C-330/91, *Commerzbank*, § 13-14.

As regards the U.K. legislation at issue, the Court observed that, *"although it applies independently of a company's seat, the use of the criterion of fiscal residence within national territory for the purpose of granting repayment supplement on overpaid tax is liable to work more particularly to the disadvantage of companies having their seat in other Member States. Indeed, it is most often those companies which are resident for tax purposes outside the territory of the Member State in question"*[1289].

It is remarkable that the ECJ does not look at the question as to whether there was equal treatment at the level of tax liability in order to assess whether the situations were comparable at the level of the tax benefit at issue. Instead, the Court in *Commerzbank* seems to start its analysis from the assumption of comparability. This would imply that the treatment at the level of tax liability is not decisive for the comparability, as one could infer from *Avoir fiscal* (cf. supra). Rather, comparability would be the general rule, and the equal treatment as regards tax liability in *Avoir fiscal* only served to underline the general rule of comparability. In other words, the observation in *Avoir fiscal* that residents and non-residents were taxed identically was not the **reason** for their comparability, but rather an *a fortiori* agreement: they were comparable to begin with, and the fact that the French legislator treated them equally only underlined this fact[1290].

Assuming that non-resident companies having a PE in another Member State are, as a general rule, comparable to residents of that Member State would entail a very broad view of comparability. The subsequent case law of the ECJ, discussed below, will reveal whether the Court has indeed adopted this position.

c. Futura

Futura concerned the tax treatment in Luxembourg of PEs of non-resident taxpayers. Two separate issues were identified by the ECJ, both of which related to the possibility for non-residents to carry-forward losses. First[1291], Luxembourg law provided that non-residents were only liable to tax in respect of 'locally received income', that is to say income earned, directly or indirectly, by their PEs located in Luxembourg. These taxpayers were allowed in Luxembourg to deduct from the total of their net income losses carried forward from previous years, provided that they were 'economically related' to income received locally. In other words, only losses arising from the non-resident taxpayer's activity in Luxembourg could be carried forward.

Asked whether this legislation was compatible with the Treaty freedoms, the Court first observed that resident taxpayers were subject to tax in Luxembourg on their worldwide income, the taxable basis not being limited to their Luxembourg activities. Consequently, although there were exemptions under which a part or even, in certain cases, all of their income earned outside Luxembourg was not subject to tax in Luxembourg, the basis for

[1289] C-330/91, *Commerzbank*, § 15.

[1290] Apparently, this was the view of the Commission in *Avoir fiscal* as well. In its reasoned opinion, the Commission argued that the freedom of establishment would be deprived of all meaning if in order to benefit from the tax credit, non-resident companies were obliged to establish subsidiaries rather than operate through permanent establishments. The Commission then added that *"the failure to grant to concession* ***was even less justifiable*** *because they were assimilated to French companies for all other tax purposes and in particular, for the purposes of determining taxable income"* (Opinion of Advocate-General Mancini, 16 October 1985, *ECR* 1986, 273, § 3; emphasis added).

[1291] The second issue, concerning the requirement to keep proper accounts, was discussed in 2.D.V.B.

assessment for resident taxpayers at any rate included profits and losses arising from their Luxembourg activities. On the other hand, for the purpose of calculating the basis of assessment for non-resident taxpayers, only profits and losses arising from their Luxembourg activities were taken into account in calculating the tax payable by them in Luxembourg. The Court thus concluded: "*Such a system, which is in conformity with the fiscal principle of territoriality, cannot be regarded as entailing any discrimination, overt or covert, prohibited by the Treaty*"[1292].

Unfortunately, the Court does not specify **why** the 'fiscal principle of territoriality' means that the measure does not constitute discrimination. More specifically, it is not clear whether this argument relates to the comparability of the situations or whether it is a justification ground. If it is a matter of comparability, the Court suggests that non-resident taxpayers with a PE in Luxembourg cannot be compared to resident taxpayers, because of the principle of territoriality. That is to say, because residents are subject to tax liability on their worldwide income and non-residents only on their income sourced in that State, these situations are not comparable. As mentioned earlier, it could be argued that the same reasoning is implicit in *Avoir fiscal*. On the other hand, it is also possible that the Court in *Futura* accepts that the situations are comparable, but nevertheless considers the domestic measure to be justified on the basis of the principle of territoriality.

In my opinion, territoriality, understood as referring to the different scope of tax liability of residents and non-residents, cannot be seen as a matter of comparability. As noted earlier, characteristics that are inherently linked to the comparative attribute should be left out of the comparability-analysis. If not, the situations would never be comparable. In the present case, the comparative attribute is the taxpayer's place of residence. Clearly, the scope of tax liability is inherently linked to that comparative attribute since residents were subject to unlimited tax liability under domestic law, while non-residents are subject to limited tax liability. Accepting that that different scope in tax liability can render the situations incomparable would deprive the prohibition of discrimination of all meaning. As a result, territoriality can only be seen as a justification-ground (see 2.F.III).

d. Royal Bank of Scotland[1293]

Royal Bank of Scotland had its seat in the U.K. and carried on business in Greece through a PE. Greek law applied a higher tax rate to profits earned in Greece by PEs of non-resident banks than the tax rate applicable to banks having their seat in Greece (40% as compared to the 'domestic' rate of 35%).

After referring to *Avoir fiscal*, the ECJ went on to determine whether, for the purposes of the taxation of profits earned in Greece, a company having its seat in Greece and a Greek PE of a company having its seat in another Member State are in a comparable situation. The Court then referred to its *Schumacker*-doctrine (which I will discuss in 2.E.I.A.b.1.a), and held that "*as far as direct taxation is concerned, the Court has held, in cases relating to the taxation of income of natural persons, that the situations of residents and non-residents in a given State are not generally comparable, since there are objective differences between them from the point of view of the source of the income and the possibility of taking account of their ability to pay tax or their personal and family circumstances. However, it has explained that, in the*

[1292] C-250/95, *Futura*, 15 May 1997, § 20-22.
[1293] C-311/97, *Royal Bank of Scotland v Greece*, 29 April 1999. See also K. EICKER, "European Court of Justice Continues to Strengthen the Situation of Permanent Establishments", *Intertax* 1999, 311.

case of a tax advantage denied to non-residents, a difference in treatment between the two categories of taxpayer might constitute discrimination within the meaning of the Treaty where there is no objective difference such as to justify different treatment on this point as between the two categories of taxpayers"[1294].

This is a remarkable departure from the position taken in *Commerzbank*. As mentioned earlier, it could be inferred from *Commerzbank* that the Court took the assumption of comparability as the starting point of its analysis. By contrast, the starting point in *Royal Bank of Scotland* is the opposite assumption of incomparability. This might seem like a very sudden shift in the Court's approach, but it has to be borne in mind that there are six years between *Commerzbank* and *Royal Bank of Scotland* and that the ECJ handed down several milestone judgments in that period, including *Schumacker*, *Wielockx* and *Asscher*. Between *Commerzbank* and *Royal Bank of Scotland*, the Court had acquired some experience concerning possible differences between residents and non-residents in direct tax matters, which might explain the different approach taken in both cases.

Thus, the general approach in *Royal Bank of Scotland* seems to be that residents and non-residents are assumed to be incomparable, unless proven otherwise (i.e. unless *"there is no objective difference such as to justify different treatment on this point as between the two categories of taxpayers"*). In respect of the Greek system at issue, the Court observed that *"as far as the method of determining the taxable base is concerned, the Greek tax legislation does not establish, as between companies having their seat in Greece and companies which, whilst having their seat in another Member State, have a permanent establishment in Greece, any distinction such as to justify a difference of treatment between the two categories of companies. […] Tax is calculated, in the case of both Greek and foreign companies, on net income or profits after deduction of the part thereof corresponding to non-taxable receipts, this being determined according to that method both for Greek companies and for foreign companies"*[1295].

This seems to be a return to the *Avoir fiscal*-approach, whereby the equal treatment at the level of tax liability renders residents and non-residents comparable. Combined with the general *Schumacker*-incomparability, the rule thus seems to be the following. The starting-point is that residents and non-residents are incomparable (on the reason for that incomparability: see infra). However, it is possible that they are comparable, i.e. if there is no relevant difference between them. In the case of companies having a PE in another Member State and resident companies of that State, there is no objective difference (and there is, therefore, comparability) if the method of determining the tax base is the same for both groups.

The Court then addresses the question whether the 'principle of territoriality', i.e. the fact that residents are subject to unlimited tax liability while non-residents are only taxed on the profits earned by the PE, means that the situations are incomparable (see supra). According to the Court, *"that circumstance, which arises from the limited fiscal sovereignty of the State in which the income arises in relation to that of the State in which the company has its seat is not such as to prevent the two categories of companies from being considered, all other things being equal, as being in a comparable situation as regards the method of determining the taxable base"*[1296].

[1294] C-311/97, *Royal Bank of Scotland*, § 26-27.
[1295] C-311/97, *Royal Bank of Scotland*, § 28.
[1296] C-311/97, *Royal Bank of Scotland*, § 29.

Once again, this statement is not very helpful when trying to understand the bigger picture. The Court does not offer any guidance as to whether 'territoriality' can ever be relied on as a reason for incomparability. It only points out that that argument is not sufficient in the case at hand, with the result that the *Avoir fiscal*-comparability (see supra) is not refuted.

According to the ECJ, that comparability was further emphasized by the tax treaty between Greece and the U.K., which treated PEs in Greece of U.K. banks as resident companies, "*so that, in that respect, it is accepted in a formal convention that it is in a situation objectively comparable to that of a Greek company*"[1297]. This is an interesting point. Most tax treaties contain a provision similar to Article 24(3) OECD MC, which requires the taxation of the PE of a non-resident not to be less favourable than the taxation of enterprises of that State carrying on the same activities. Accepting this position would, in most cases, entail a *de facto* reversal of the *Schumacker*-incomparability: as most tax treaties require PEs to be treated as resident companies, the general rule would be comparability. However, the reference to the tax treaty most likely serves as an *a fortiori*-argument, to stress the fact that the situations are comparable (by reason of their identical treatment at the level of tax liability).

e. Saint Gobain[1298]

Saint-Gobain SA, a company incorporated under French law whose seat and place of management were located in France, had a PE in Germany. In Germany, Saint-Gobain SA was subject to limited tax liability, because neither its seat nor its place of management were located there. The limited tax liability related to both the income earned in Germany through its PE and to the assets held in its PE. The German tax administration refused to grant Saint-Gobain SA certain tax benefits relating to the taxation of dividends from shares in foreign companies because those benefits were restricted to resident companies.

Through the operation capital of the PE, Saint-Gobain SA held shareholdings in a U.S. company and two German companies. The two German companies were subsidiaries of Saint-Gobain SA and formed part of a group for German tax purposes. In the case of a group treated as a single entity for tax purposes ('Organschaft'), the parent company declared to be solely liable for the tax on the group's aggregated result. The profits and losses of the subsidiaries were incorporated in the profits and losses of the parent and subject to tax, for which the parent was liable, on the condition that there was a profit-transfer agreement between the subsidiaries and the parent and that the subsidiaries were financially, economically and organisationally integrated into a German undertaking, or, on certain conditions, into the German PE of a foreign company (as was the case with the Saint-Gobain group).

The profits of the two German companies, which were transferred to the PE under the profit-transfer agreement, included group dividends distributed by foreign subsidiaries (more specifically, a Swiss subsidiary, an Austrian subsidiary and an Italian subsidiary). All the conditions for group treatment in Germany were fulfilled. Consequently, those dividends were directly attributed to the German PE, and therefore to the income of Saint-Gobain SA, subject to limited tax liability in Germany.

[1297] C-311/97, *Royal Bank of Scotland*, § 29.
[1298] C-307/97, *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v Finanzamt Aachen-Innenstadt*, 21 September 1999.

The German tax administration refused to grant the PE three tax concessions designed to prevent international double taxation on dividends[1299]. First, the exemption from German corporation tax[1300] was refused for the dividends received by the PE from the U.S. and Switzerland on the ground that the tax treaties between Germany and those two States, which provided for such exemption, restricted it to, respectively, German companies[1301] and companies subject in Germany to unlimited tax liability[1302].

Secondly, although the German tax administration allowed Saint-Gobain SA the 'direct credit' provided for in the German income tax law, it refused the 'indirect credit' provided for in the same law. The direct credit consisted of a credit against the German corporation tax payable by Saint-Gobain SA on dividends received through the PE for the foreign tax which it had already paid and which had been withheld at source in the various countries in which the distributing companies were established. The indirect credit, a credit for the foreign corporation tax levied on the profits distributed by the foreign subsidiaries and sub-subsidiaries of Saint-Gobain SA in the countries in which they were established, was refused because the German law restricted that concession to companies subject in Germany to unlimited tax liability.

Put briefly, a German resident company would have received relief for underlying tax either by way of credit under German domestic law for the dividends from Austria and Italy (as there was no provision for relief for underlying tax in the applicable treaties with those countries) or by way of exemption under the treaty with Switzerland or the U.S. As both the domestic relief measure and the relief provisions of the relevant treaties were limited to German residents, the PE was not entitled to these benefits.

> Two remarks are in order here. First, the exemption under the German/U.S. treaty was available to German residents holding directly at least 25% of the voting shares of the U.S. company (Article XV(1)(b)(1)(aa) of the treaty). The PE in the case at hand only owned 10.2% of the shares of the U.S. company. Therefore, even if the PE had been a German resident, it would not have been entitled to the exemption under the treaty. However, a unilateral provision in German domestic law reduced the threshold to 10%[1303]. As a result, a German resident holding between 10% and 25% of the shares would be entitled to the exemption by virtue of the unilateral extension of the treaty relief.
>
> Secondly, the exemption in the treaty with Switzerland was linked to the availability of the indirect credit under German domestic law. The Swiss-source dividend was

[1299] As a side-note, it should be mentioned that the decision does not address the point that the disadvantage incurred by the taxpayer would not have arisen if there had been no Organschaft. In that case, the two German subsidiaries holding the shares would have been entitled to relief, either under domestic law (for the Italian and Austrian dividends) or under treaty law (for the Swiss dividends). However, the issue would then still arise with respect to the U.S. dividend, which was received directly by the PE. Moreover, this restatement of the facts would raise the same issue of discrimination, formulated a bit differently: if a German resident company can form an Organschaft with a German subsidiary holding shares in foreign companies and be entitled to relief on dividends from those shares, then is it not discriminatory to deny such relief to the German PE of a company resident in another Member State forming an Organschaft with its German 'subsidiary'? See also J. OLIVER, "Entitlement of a permanent establishment to third State treaty benefits", *B.T.R.* 2000, 178.

[1300] Which was a form of international group relief from corporation tax in respect of profits distributed between subsidiaries and the parent company ('internationales Schachtelprivileg').

[1301] Art. XV of the tax treaty between Germany and the U.S. According to Art. II(1)(f) of that treaty, a 'German company' was a legal person having its business management or seat in Germany.

[1302] Art. 24 of the treaty between Germany and Switzerland.

[1303] See Opinion of Advocate-General Mischo in C-307/97, *Saint-Gobain*, § 8.

> exempt from tax in Germany if, under German tax law, the Swiss tax levied on the profits of the distributing company could also be credited against German corporation tax to be levied on the German company[1304]. In other words, German residents could only claim the exemption under the treaty where German unilateral relief by way of credit would also be available. The importance of this nuance will be discussed in 2.E.II.C.b.

Thirdly, the tax authorities did not allow Saint-Gobain SA the capital tax concession for international groups in respect of the shareholding in the U.S. company. Under German domestic law, that concession was restricted to resident companies.

Saint-Gobain SA argued that the exclusion of its German PE from the enjoyment of these three benefits violated the freedom of establishment.

The ECJ first established that the refusal to grant the concessions placed the German PE of a non-resident company in a less favourable situation than resident companies since that refusal made it less attractive for non-resident companies to hold shareholdings through a German PE than it was to hold them through a German subsidiary[1305]. This restricted the freedom to choose the most appropriate legal form for the pursuit of activities in another Member State.

The German government argued that the situations of resident companies and non-resident companies are not, in general, comparable. More specifically, the German government maintained that *"non-resident companies are subject in Germany to limited tax liability [on the income received through their branches in Germany and the assets held in those branches] whereas resident companies are subject in Germany to unlimited tax liability"*. Once again, this is the 'territoriality' argument, worded in terms of comparability (see supra).

The ECJ responds to this argument by stating that, as regards liability to tax on dividends received in Germany from shares in foreign subsidiaries and sub-subsidiaries and on the holding of those shares, non-resident companies having a PE in Germany and resident companies are in objectively comparable situations. First, **the receipt of dividends** in Germany is liable to (income) tax there irrespective of whether the recipient is a resident company or a non-resident company, since the latter receives them through a PE located in Germany. Secondly, **shareholdings** in foreign subsidiaries and sub-subsidiaries in Germany are liable to (capital) tax there irrespective of whether they are held by a resident company or

[1304] In the version applicable at the relevant time (i.e. before it was amended in 1989), Art. 24(1)(1)(b) of the German/Swiss treaty provided: *"Dividenden im Sinne des Artikels 10, die eine in der Schweiz ansässige Kapitalgesellschaft an eine in der Bundesrepublik Deutschland unbeschränkt steuerpflichtige Kapitalgesellschaft ausschüttet, wenn nach deutschem Steuerrecht auf eine davon zu erhebende deutsche Körperschaftsteuer auch eine vom Gewinn der ausschüttenden Gesellschaft erhobene schweizerische Steuer angerechnet werden könnte"* (See also Opinion of Advocate-General Mischo in C-307/97, *Saint-Gobain,* § 9).
[1305] C-307/97, *Saint-Gobain,* § 38-41. Here, a distinction was made between the first two concessions at issue (i.e. the international group relief from corporation tax and the indirect credit) and the third concession (i.e. the capital tax concession). It was not contested that the refusal to grant the first two concessions placed the German PE of a non-resident company at a disadvantage. However, the German government argued that, as far as the capital tax concession was concerned, the situation of the non-resident company's PE was not less favourable than that of the resident subsidiary of a non-resident company which does receive this tax concession. Pursuant to a provision in the German Law on the valuation of assets, the tax burden on the non-resident company was the same irrespective of whether the shareholdings were held through a PE or through a subsidiary. However, Saint-Gobain contended that this provision had been set aside in its case by virtue of the tax treaty between France and Germany. The ECJ left it to the German court to determine whether the refusal to grant the capital tax exemption to the PE of a French company put it in a situation less favourable than that of a German subsidiary of a French company. This aspect will be discussed in 2.E.II.C.b.

by a non-resident company, since the latter holds those shares in a PE located in Germany[1306]. In effect, this is an application of the *Avoir fiscal*-comparability (as confirmed in *Royal Bank of Scotland*, see supra): the basic *Schumacker*-incomparability of residents and non-residents (see infra) is refuted by the identical treatment at the level of tax liability. The identical tax treatment in this respect (and the ensuing comparability) is split up in two aspects, the first of which relates to the income tax on the dividends (and, thus, to the first two concessions at issue) and the second of which relates to the capital tax on the shareholdings (and, thus, to the third concession).

The ECJ continues by holding that *"the situations of resident companies and of non-resident companies are made even more comparable by the fact that the difference in treatment applies only as regards the grant of the tax concessions in question."* Those concessions allowed resident companies either to deduct from corporation tax the amount of foreign tax levied on dividends from shareholdings in foreign companies (the second concession) or to exclude those dividends or holdings from their income and from their global assets which were taxable in Germany (the first and third concession). The refusal to grant those advantages to non-resident companies having a PE in Germany produces the result *"that their tax liability, theoretically limited to 'national' [(i.e. German)] income and assets, comprises in actual fact dividends from foreign sources and shareholdings in foreign companies"*.

In the case at hand, the ECJ therefore concludes that *"the difference between limited tax liability and unlimited tax liability is certainly not relevant in so far as the global income and assets do not include dividends received from foreign companies or shareholdings in foreign companies, owing to the grant of the tax concessions in question, for which taxpayers subject to limited tax liability cannot qualify"*[1307].

The wording used by the Court is a bit odd. It is not entirely accurate to say that two situations *"are made even more comparable"* by a certain fact. Comparability is not a matter of degree, but a matter of kind: situations are either comparable or not[1308]. Consequently, a certain circumstance cannot make two situations 'more comparable' than they already were. So it seems more likely that this statement serves as an *a fortiori*-argument, to underline the comparability already established on the basis of the identical treatment at the level of tax liability[1309].

But this statement also reveals a more fundamental issue, namely that the Court seems to consider territoriality as an element of the comparability-test (see supra). In particular, the *a fortiori*-argument here is that the tax liability of the PE of a non-resident, which is theoretically limited to 'national' income and assets, also includes foreign dividends and shares in foreign companies. That argument reinforces the Court's conclusion that the difference between limited and unlimited tax liability (i.e. the argument for incomparability put forward by the German government) is irrelevant in the present case, particularly because the 'global income and assets' (i.e. the taxable base in case of unlimited tax liability) do not include dividends received from foreign companies or shareholdings in foreign companies, **precisely due to the tax concessions** which are unavailable to non-residents. Put briefly, the

[1306] C-307/97, *Saint-Gobain*, § 47.
[1307] C-307/97, *Saint-Gobain*, § 48.
[1308] See infra, on the concept of 'proportional comparability', 2.F.II.
[1309] Compare this to the *a fortiori*-argument given in *Royal Bank of Scotland*: there it was held that the comparability of resident companies and PEs of non-resident companies is underlined by the acceptance of their comparability in a tax treaty (see supra).

unavailability of the tax concessions for PEs of non-residents underlines their comparability to resident companies by demonstrating the irrelevance of the territoriality-argument: the different scope of tax liability does not render both categories incomparable, as the exclusion from the tax benefits actually broadens the non-resident's scope of tax liability as compared to that of a resident (i.e. by including taxable items which are excluded in the case of residents)[1310].

But territoriality should not be considered as an element of the comparability-test. As noted above, where the different scope of tax liability is determined on the basis of the taxpayer's residence, it is clear that that scope of tax liability is inherently connected to the comparative attribute. So there was no reason for the Court to refute the relevance of the scope of tax liability: even if that characteristic is relevant, it should still be disregarded on the basis that it is inextricably linked to the comparative attribute.

Three grounds of justification were subsequently examined. First, the German government invoked the need to prevent a reduction in tax revenue. In the case of resident companies, the loss in tax revenue due to the grant of the concessions is compensated for by the subsequent taxation of a dividend distribution by the parent company. However, if Germany were to grant these concessions to non-residents with a PE in Germany, it could not compensate for the resulting reduction in revenue by taxing a subsequent dividend distribution. The ECJ responds, quite concisely, that such a reduction of tax revenue *"cannot be regarded as a matter of overriding general interest which may be relied upon to justify unequal treatment"*.

Secondly, the German government argued that the different treatment was justified by the advantage which PEs enjoy in comparison with resident subsidiaries as regards the transfer of profits to the non-resident dominant or parent company. As this argument concerns the disadvantage-test, it will be discussed in 2.E.I.B.c.3.

As a final justification, the German government argued that the conclusion of bilateral treaties with a non-Member State did not come within the sphere of EU competence. This argument will be discussed in 2.E.II.C.b.

In conclusion, the ECJ ruled that the freedom of establishment precluded the exclusion of a German PE of a company resident in another Member State from the enjoyment of the tax concessions in question, on the same conditions as those applicable to companies resident in Germany.

f. CLT-UFA[1311]

CLT-UFA was a Luxembourg company with a PE in Germany. CLT-UFA was subject to corporate tax in Germany in respect of the income generated by the PE at a rate of 42%. By contrast, German resident companies were subject to corporation tax which, if the profits had been retained, would have been charged at a rate of 45%. That high tax rate could, however, have been decreased to 33.5% if the profits were distributed to the parent company (or 30%, depending on the moment the profits were distributed).

[1310] Worded as such, this argument seems to balance on the verge of the comparability- and disadvantage-test. In particular, the core idea is that the exclusion from the tax concessions causes a disadvantage (i.e. a broader tax base) as compared to resident companies.
[1311] C-253/03, *CLT-UFA SA v Finanzamt Köln-West*, 23 February 2006.

CLT-UFA argued that the application of different tax rates infringed the freedom of establishment of non-resident companies, since the free choice as to the appropriate legal form in which to pursue their activities in another State (i.e. a PE or a subsidiary) was distorted.

Referring to *Avoir fiscal*, the ECJ first observed that the freedom of establishment implied the freedom to choose the appropriate legal form in which to pursue activities in another Member State and that that freedom of choice should not be limited by discriminatory tax provisions. Therefore, the freedom to choose the appropriate legal form in which to pursue activities in another Member State *"primarily serves to allow companies having their seat in a Member State to open a branch in another Member State in order to pursue their activities under the same conditions as those which apply to subsidiaries"*[1312].

Applied to the German regime at issue, the Court notes that the rate of 42% applicable to the profits of PEs of non-resident companies *"constitutes, generally speaking, unfavourable treatment in relation to the tax rate reduced to 33.5%, or even 30%, which is applicable to the profits of the subsidiaries of such companies."* As a result, the higher tax rate applicable to PEs renders the possibility for non-resident companies of exercising their freedom of establishment through a PE less attractive[1313].

As to the comparability-issue, two arguments were brought forward in defense of the German regime. First, it was submitted that profits, distributed by a subsidiary to its parent company, are no longer assets of the subsidiary, whereas profits transferred by a PE to its head office continue to be part of the internal assets of the same company. According to the German government, that difference led the national legislature to exclude the application of the reduced tax rate to profits made by PEs. In this respect, the Court observed that, in both cases the profits were made available to the company controlling the subsidiary and the PE respectively. The only real difference between the two situations *"lies in the fact that the distribution of the profits of a subsidiary to its parent company presupposes the existence of a formal decision to that effect, whereas the profits of a branch of a company are part of the assets of that company even in the absence of a formal decision to that effect."* Moreover, even if the profits distributed by a subsidiary to its parent company were no longer part of the assets of that subsidiary, those profits could still be made available to that subsidiary by its parent company in the form of share capital or a shareholder loan. As a result, the fact that profits distributed by a subsidiary to its parent company are no longer part of that subsidiary's assets does not constitute a relevant difference which would enable the German legislator to apply a lower tax rate to the profits of a subsidiary as compared to the profits of a PE[1314].

Secondly, it was argued that the reduced tax rate applicable to subsidiaries could be explained by the fact that tax charged on a subsidiary must be set off against the tax due from the beneficiary parent company which is subject to unlimited tax in Germany, in order to avoid

[1312] C-253/03, *CLT-UFA*, § 14-15.
[1313] C-253/03, *CLT-UFA*, § 16-17. From this observation, the Court infers that *"a national law such as the one in dispute in the main proceedings restricts the freedom to choose the appropriate legal form in which to pursue activities in another Member State."* This is a clear example of a discrimination-issue being labelled as a restriction-issue. The German measure is clearly discriminatory as it applies a higher tax rate to the subject of comparison (PEs of non-resident companies) as compared to the object of comparison (resident companies). As mentioned before, there is no difference between the discrimination-approach and the restriction-approach in cases such as this. Rather, the restriction of the freedom is the consequence of the discrimination (see supra, 2.D.V.A).
[1314] C-253/03, *CLT-UFA*, § 22-25.

double taxation of those taxpayers[1315]. Because this is actually an issue concerning the disadvantage-test, it will be addressed in 2.E.I.B.c.4.

Finally, the Court indicates that the German rules on the determination of the taxable base do not distinguish between non-resident companies having a PE in Germany and subsidiaries of such companies (i.e. German resident companies)[1316]. This is, of course, the *Avoir fiscal*-comparability. For the sake of clarity, it might have been better to start off the analysis with this observation, followed by a rebuttal of the two arguments for incomparability. Nevertheless, the *CLT-UFA*-judgment is another confirmation of the *Avoir fiscal*-comparability. Neither the difference between distribution of profits by a subsidiary to its parent and the transfer of profits within a company, nor the possibility of double taxation in the case of subsidiaries detracts from this comparability.

g. Conclusion

This overview of case law concerning the taxation of PEs illustrates the basic mechanism of the ECJ's comparability-test. The determination of the subject and object of comparison is straightforward in this string of cases: a non-resident company, whose presence in the host State materializes through the existence of a PE, is compared to a resident company. The basic *Schumacker*-incomparability (i.e. residents and non-residents are, as a rule, incomparable; see infra) is the starting point, but in most cases this 'global' incomparability is superseded by the specific *Avoir fiscal*-comparability: if the tax liability in respect of the item of income at issue is the same, then both situations are comparable as regards tax concessions relating to those items of income.

Thus, it seems that the only situation in which a different treatment of PEs as compared to resident companies is possible, is where the national legislation draws a distinction between both categories as regards the manner of determining the taxable base. Other differences, such as the difference between the distribution of profits by a subsidiary to its parent company and the transfer of profits within a company (cf. *CLT-UFA*), are irrelevant.

The Court has also referred to several *a fortiori*-arguments, which underline the comparability of both categories, for instance the acceptance of the comparability in a tax treaty (cf. *Royal Bank of Scotland*). Of course, these arguments are *obiter dicta*, as the comparability has already been determined on the basis of the identical treatment at the tax liability-level.

Finally, it should be noted that the Court's reference to 'the fiscal principle of territoriality' has created some confusion in literature. It has been suggested that this is actually the same as the fiscal cohesion-justification[1317], or that it serves as a type of *Keck*-exception (i.e. that measures based on the principle of territoriality remain ouside the scope of the freedoms)[1318]. On the basis of *Saint-Gobain*, it seems that the ECJ considers 'territoriality' to mean that residents and non-residents are generally incomparable because, under international tax law, residents are subject to unlimited tax liability while non-residents are subject to limited tax liability. But that is not entirely accurate. Characteristics that are inherently linked to the comparative attribute should be disregarded in the comparability-test. As a result, the

[1315] C-253/03, *CLT-UFA*, § 21.
[1316] C-253/03, *CLT-UFA*, § 29.
[1317] E.g. B. TERRA and P. WATTEL, *European Tax Law*, 42 and 130-131.
[1318] E.g. A. ZALAZINSKI, "The limits of the EC concept of direct tax restriction on free movement rights, the principles of equality and ability to pay, and the interstate fiscal equity", *Intertax* 2009, 286 and 295-296.

difference in a non-resident's scope of tax liability as compared to a resident's scope of tax liability should be disregarded. If not, the subject and object of comparison would be incomparable by definition. Of course, it is possible that the territoriality-argument comes up for discussion in the justification-test (see 2.F.III), but that is not the same as accepting that the situations are incomparable on that basis[1319].

As mentioned earlier, non-discrimination in direct taxation is essentially concerned with (horizontal) ability to pay: taxpayers with the same ability to pay should carry the same tax burden. As a result, the starting point in assessing whether situations are comparable should be their ability to pay. However, since ability to pay is very difficult to measure in practice, indirect indicators of ability to pay are generally used in practice, the most straightforward of which is the taxpayer's income. The Court clearly takes this approach with respect to person- and family-related benefit (albeit in an unconvincing manner; see 2.E.I.A.b.1) but it could be said that this approach also underlies the Court's case law on the taxation of inbound PEs.

In particular, it could be argued that the Court generally assumes that a non-resident is not comparable to a resident because their ability to pay in the source State is different. That is to say, the Court seems to assume that, because a resident is subject to worldwide tax liability in his home State (see supra: territoriality), he will automatically be taxable on the majority of his income there. In other words, the ECJ seems to assume that a taxpayer's scope of tax liability reflects his ability to pay tax. But that is not necessarily the case. It is quite possible that the majority of a taxpayer's income is taxable exclusively in the source State. There is no necessary connection between the scope of a taxpayer's liability to pay tax in a certain State and the amount of income that is actually taxable in that State. Therefore, there is no necessary connection between the taxpayer's scope of tax liability (as reflected by the idea of territoriality) and his ability to pay tax.

On the other hand, since income is the least imperfect indicator for the ability to pay, a non-resident is generally not comparable to a resident since the former's income is generally not centered in the source State. However, that basic incomparability is not applicable where the taxation of a specific item of income is concerned (e.g. relief for double taxation of dividends in *Avoir fiscal* and *Saint-Gobain*; interest on tax refund in *Commerzbank*; the tax rate on PE profits in *Royal Bank of Scotland* and *CLT-UFA*): in such cases, the comparability is determined by the tax treatment of that item of income in the source State. If the source State taxes both residents and non-residents in respect of such income, non-residents are comparable to residents with respect to tax benefits relating to that income[1320].

To summarize: if the Court considers that the principle of territoriality in itself, i.e. the fact that residents are subject to unlimited tax liability while non-residents are subject to limited tax liability, can render the situations incomparable, then that position should be dismissed. Since the scope of tax liability is inextricably linked with the comparative attribute, it can only function as a justification ground (see 2.F.III). On the other hand, the Court is correct if it considers that residents are generally incomparable to non-residents because their ability to pay differs. And, due to a lack of viable alternatives, ability to pay is best measured by looking at the taxpayer's income and the place where that income is taxable. But it would be incorrect to assume that it is **because of** the different scope of tax liability that the ability to pay differs. There is no necessary correlation between those factors.

[1319] The *Bosal*-judgment, and its implications for this interpretation of *Futura*, will be discussed in 2.E.I.A.b.4.c.
[1320] See also 2.E.I.A.b.2.

2. Horizontal comparisons

The traditional non-discrimination test relies on a vertical comparison between cross border situations and purely domestic situations. Nevertheless, there have been suggestions that an extension towards two types of horizontal comparisons may be possible. First of all, the case law discussed above seems to imply that the choice between different types of cross-border secondary establishment must not be distorted (i.e. the comparison is made between, for instance, the taxation of subsidiaries and the taxation of permanent establishments)[1321].

> Yet, it should be pointed out that the interpretation of the freedom of establishment as guaranteeing a free choice of legal form is not universally accepted. It has been argued[1322] that there can only be discrimination contrary to the fundamental freedoms if the distinction made by the domestic measure at issue **is connected to the cross-border aspect of the case**, e.g. a distinction on the basis of residence or a distinction between investments made in the State of residence and investments made in another Member State. However, in the cases discussed here, the distinguishing criterion is merely the legal form of the secondary establishment. That criterion does not have any cross-border aspects, that is to say, PEs can be formed both in the State of residence and in another Member State, as can subsidiaries. Distinguishing between both legal forms does not entail any discrimination on the basis of a cross-border aspect. Put differently, the fact that taxpayers are protected against discrimination on the basis of cross-border aspects does not mean that they are automatically protected against discrimination on the basis of legal form.
>
> While there is some merit in this argument, it should be stressed that it can only relate to the home State of the taxpayer. Obviously, when the source State differentiates between PEs of non-residents and subsidiaries of non-residents, it discriminates on the basis of residence (i.e. between resident subsidiaries and non-residents having a PE in the source State). The nuance touched upon here only concerns the situation where the taxpayer's State of origin differentiates between subsidiaries and PEs, regardless of whether they are situated in that State or elsewhere. In such a case, I agree with the argument that there is no discrimination because no distinction is made on the basis of a prohibited criterion. Nevertheless, it could also be argued that this position is difficult to reconcile with the Court's clear reference in *Saint-Gobain* to *"the freedom*

[1321] E.g. C-270/83, *Avoir fiscal*, § 22: *"the fact that insurance companies whose registered office is situated in another Member State are at liberty to establish themselves by setting up a subsidiary in order to have the benefit of the tax credit cannot justify different treatment. The second sentence of the first paragraph of Article 52 expressly leaves traders free to choose the appropriate legal form in which to pursue their activities in another Member State and that freedom of choice must not be limited by discriminatory tax provisions"*; C-307/97, *Saint-Gobain*, § 42-43: *"the refusal to grant the tax concessions in question to the permanent establishments in Germany of non-resident companies makes it less attractive for those companies to have intercorporate holdings through German branches, since under German law and double-taxation treaties the tax concessions in question can only be granted to German subsidiaries […] which thus restricts the freedom to choose the most appropriate legal form for the pursuit of activities in another Member State, which the second sentence of the first paragraph of Article 52 of the Treaty expressly confers on economic operators. The difference in treatment to which branches of non-resident companies are subject in comparison with resident companies as well as the restriction of the freedom to choose the form of secondary establishment must be regarded as constituting a single composite infringement of Articles 52 and 58 of the Treaty."* In extenso: W. SCHÖN, "The Free Choice between the Right to Establish a Branch and to Set-up a Subsidiary – a Principle of European Business Law", *EBOR* 2001, 339-364.

[1322] A. CORDEWENER, M. DAHLBERG, P. PISTONE, E. REIMER and C. ROMANO, "The tax treatment of foreign losses: Ritter, M & S and the way ahead (part two)", *European Taxation* 2004, 230-232.

to choose the most appropriate legal form for the pursuit of activities in another Member State"[1323].

Clearly, the situation referred to here – where the taxpayer's State of origin differentiates between subsidiaries and PEs regardless of where they are situated – should also be distinguished from the situation where the taxpayer's State of origin distinguishes between PEs established in another Member State and non-resident subsidiaries. Since that situation concerns the comparison between a resident (the taxpayer and his PE) and a non-resident (the subsidiary), the starting point is that the situations are incomparable because of the differences in ability to pay (see infra).

Obviously, the specific case of cross-border secondary establishment does not lead to an actual extension towards horizontal comparisons: assuming that the comparison is made between a subsidiary and a PE, the comparison is, to a significant degree, still vertical. Indeed, the subsidiary is a resident of the host State, while the PE is part of the (non-resident) head office. Accordingly, the comparison is still made between a resident and a non-resident[1324].

An actual extension towards horizontality would consist of the comparison between two equivalent cross-border situations, both relating to different Member States. Take, for instance, the hypothetical case where Member State A would grant tax advantages to PEs of State B companies, and denies these tax advantages to PEs of State C companies. In effect, this issue raises raises the question whether the fundamental freedoms require Member States to grant each other most favoured nation (MFN) treatment[1325].

At first glance, it seems clear that MFN-treatment is required in the context of the TFEU. First, Article 18 TFEU, which is the general expression of the non-discrimination principle in the TFEU and as such underlies the specific expressions thereof in the fundamental freedoms, prohibits **any** discrimination on grounds of nationality. Therefore, it should make no difference whether the discrimination at issue is between nationals and non-nationals, between residents and non-residents (i.e. indirect discrimination) or between different categories of non-nationals or non-residents. Furthermore, it is clear that horizontal types of discrimination are as much of an obstruction to the internal market as vertical types of discrimination. From an internal market-perspective, it makes no difference whether residents of Member State A are being discriminated against in Member State B as compared to

[1323] C-307/97, *Saint-Gobain*, § 42.

[1324] See also Opinion of Advocate-General Maduro in C-446/03, *Marks & Spencer*, 7 April 2005, § 47 (*"It is clearly apparent that in all those cases discrimination in the choice of form of establishment is inextricably bound up with discrimination as to the choice of place of residence. That is owing to the fact that the State concerned chose to place the different forms of establishment on the same footing for the purposes of taxation in its territory. If in such a case a difference of treatment is none the less established it is because it in fact conceals a case of discrimination on the ground of nationality as against the companies operating those establishments"*) and A. SCHNITGER, "The CLT-UFA Case and the Principle of Neutrality of Legal Form", *European Taxation* 2004, 524-525.

[1325] I use the term 'most favoured nation' in its traditional conception, i.e. the obligation to grant a certain category of non-residents (or non-nationals) the most beneficial treatment granted to any other category of non-residents (or non-nationals). Another type of 'most favoured nation'-issue arises where two residents (or nationals) are treated differently depending on the State with which they develop a cross-border relationship (e.g. resident A invests in State X, resident B invests in State Y; resident A is treated more favourably than resident B because the provisions of the tax treaty between the State of residence and State X are more beneficial than those of the treaty with State Y). In most cases, this is a matter for the domestic non-discrimination provisions. Insofar as this issue requires the application of the fundamental freedoms, its solution should be the same as that of the traditional MFN-issue.

residents of Member State B or as compared to residents of Member State C. However, the ECJ has not accepted the existence of an MFN-requirement in the fundamental freedoms. Because this issue is closely related to the influence of tax treaties on the comparability-test, it will be discussed in 2.E.I.A.b.9.

b. Constructing the comparison II: what are the relevant characteristics?

As mentioned earlier, residents and non-residents are normally not in the same circumstances in the context of direct taxation. This is generally explained by the differences that exist between those categories with respect to their respective ability to pay. In normal circumstances, a taxpayer will earn the majority of his income in his home State, which means that his ability to pay in the source State differs from that of a resident of the source State. Given this different position of both States, it is normally up to the residence State to take into account the taxpayer's personal and family circumstances. The ECJ has held in *Schumacker* that the situation is different when the taxpayer earns most of his income in the source State, in which case it is up to that State to take the taxpayer's personal and family circumstances into account.

However, there is an important distinction to be drawn. The *Schumacker*-reasoning, referred to above, only applies with regard to **person-related** tax benefits. By contrast, residents and non-residents are generally comparable with regard to **income-related** tax benefits. Consequently, different treatment as regards the latter type of benefits will normally constitute discrimination, regardless of the amount of income earned by the taxpayer in the source State.

As a result, the comparisons made in the cases discussed in this section do not turn entirely on the comparative attribute: other characteristics are included in the comparison as well. In other words, the comparison is not entirely controlled by the fact that the subject and object of comparison are each other's mirror images as regards the comparative attribute (first step of the Aristotelian concept of discrimination; cf. Part I and supra, 2.E.I.A.1). Instead, the comparison is constructed on the basis of characteristics other than the comparative attribute, which render the subject and object of comparison either comparable or incomparable (second step of the Aristotelian concept of discrimination; cf. Part I).

Hereafter, I will discuss the ECJ's case law according to different themes and try to identify the elements which render the subject and object of comparison comparable or incomparable. One could argue that the Court's case law would gain in clarity by using one single characteristic to determine comparability. For instance, from the perspective of the internal market, a relevant characteristic to determine comparability could be the substitutability between the cross-border transaction and the domestic transaction: since the internal market is aimed at guaranteeing undistorted competition between market agents, the only relevant question in comparing them is whether they compete with each other[1326]. If there is competition between them, they are comparable from the perspective of the internal market's purpose. Yet, that approach can only be applied to economic operators who exercise their free movement rights in the context of their business activities, while the Court's case law has been extended to cover numerous other issues. Furthermore, the discussion of the Court's case law will reveal that there are a number of additional issues apart from substitutability to be considered in the different areas where the free movement provisions affect the direct tax legislation of the Member States.

[1326] See e.g. J. ENGLISCH, "Taxation of cross-border dividends and EC fundamental freedoms", *Intertax* 2010, 203.

1. Person-related benefits: incomparability is the general rule

a. The Schumacker-doctrine

1. Schumacker

Mr Schumacker, a Belgian national, had always lived in Belgium with his wife and their children. After first working in Belgium, he was employed in Germany from 15 May 1988 until 31 December 1989, but he continued to live in Belgium. Mrs Schumacker, who was not employed, drew unemployment benefit in Belgium only during 1988. Since 1989, Mr Schumacker's wages were the household's sole income.

German income tax legislation applied different tax regimes to wages, depending on the residence of the employees receiving the wages. The German tax on employment income was deducted at source by the employer.

For purposes of this deduction at source, residents were divided into several categories. Category I (the 'general tax tariff') consisted of unmarried residents. Married residents who were not permanently separated fell within Category III (the 'splitting tariff'), provided that both spouses were resident in Germany and were subject to unlimited taxation. The German splitting regime was introduced to mitigate the progressive nature of the income tax rates. Under the splitting regime, the spouses' total income was aggregated, notionally attributed to each spouse as to 50% and then taxed accordingly. If the income of one spouse was greater than that of the other, this system levelled out the taxable income and reduced the progressive increase in the scale of the tax. Furthermore, resident employees also benefited from several other tax advantages, such as an annual adjustment of wage tax and the possibility to set off against employment income losses incurred in respect of other income. Finally, tax on resident employees was assessed according to overall ability to pay, that is to say having regard to all the other income received by the taxpayer and to his personal and family circumstances (family expenses, welfare expenses, etc.).

These benefits were not applicable to non-residents. Non-resident employees always fell within Category I, regardless of their family circumstances. Consequently, they did not qualify for the tax benefit of splitting and married employed persons were treated in the same way as unmarried persons. Furthermore, a simplified tax procedure was applied to non-residents. Their liability to income tax was deemed to be definitively discharged by the employer's monthly deduction at source. They were excluded both from the annual wages tax adjustment made by the employer and from the annual income tax assessment by the administration. Consequently, they could not qualify for reimbursement of any overpaid tax at the end of the year. Finally, non-residents were not entitled to deduct their social expenses (premiums in respect of old-age, sickness or invalidity insurance) where they exceeded the flat rates laid down in the taxation scale.

Pursuant to the Belgian/German tax treaty, Mr Schumacker's wages were taxable in Germany. The German tax administration applied the non-residents' regime, described above. Mr Schumacker asked the tax administration to recalculate his taxes on the basis of Category III (i.e. the regime applicable to resident married persons) but the administration dismissed his claim. Ultimately, the ECJ was asked whether the free movement of employees had been violated by the German regime, firstly by applying a higher rate of tax to non-residents, secondly by restricting the adjustment procedures to residents.

The ECJ starts by observing that *"in relation to direct taxes, the situations of residents and of non-residents are not, as a rule, comparable"*[1327]. This incomparability is explained by the fact that a non-resident usually earns only a minor part of his income in the source State, whereas most of his income arises in his State of residence. Moreover, *"a non-resident's personal ability to pay tax, determined by reference to his aggregate income and his personal and family circumstances, is more easy to assess at the place where his personal and financial interests are centred. In general, that is the place where he has his usual abode. Accordingly, international tax law, and in particular the [OECD MC], recognizes that in principle the overall taxation of taxpayers, taking account of their personal and family circumstances, is a matter for the State of residence.*[1328]*"*

As a result, *"the situation of a resident is different in so far as the major part of his income is normally concentrated in the State of residence. Moreover, that State generally has available all the information needed to assess the taxpayer's overall ability to pay, taking account of his personal and family circumstances. Consequently, the fact that a Member State does not grant to a non-resident certain tax benefits which it grants to a resident is not, as a rule, discriminatory since those two categories of taxpayer are not in a comparable situation"*[1329]. This means, in general, that the free movement of workers is not violated by a national measure pursuant to which non-resident employees are taxed more heavily than resident employees.

However, the position is different if the non-resident receives no significant income in his State of residence and obtains the major part of his taxable income from an activity performed in the State of employment, with the result that his State of residence is not in a position to grant him the benefits resulting from the taking into account of his personal and family circumstances. The ECJ continues that *"there is no objective difference between the situations of such a non-resident and a resident engaged in comparable employment, such as to justify different treatment as regards the taking into account for taxation purposes of the taxpayer's personal and family circumstances. In the case of a non-resident who receives the major part of his income and almost all his family income in a Member State other than that of his residence, discrimination arises from the fact that his personal and family circumstances are taken into account neither in the State of residence nor in the State of employment"*[1330].

[1327] C-279/93, *Schumacker*, § 31.
[1328] The Court was likely referring to the second sentence of Art. 24(3) OECD MC, which provides that the PE non-discrimination provision *"shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents"*. Advocate-General Léger expressly referred to this sentence in his Opinion in *Schumacker*: *"The different systems to which residents and non-residents are subject make it possible to avoid duplication of benefits. That is why, under Article 24(3) of the OECD model convention on double taxation, a contracting State is not obliged to grant residents of another contracting State the personal deductions, reliefs and rebates which it grants its own residents. There is thus no discrimination between a person subject to unlimited taxation and one subject to limited taxation because they are not in comparable circumstances"* (§ 62-63 of the Opinion). According to Comm. OECD to Art. 24, § 22, the second sentence of Art. 24(3) was designed mainly to ensure that individuals having a PE in the other contracting State *"do not obtain greater advantages than residents, through entitlement to personal allowances and reliefs for family responsibilities, both in the State of which they are residents, by the application of its domestic laws, and in the other State by virtue of the principle of equal treatment. Consequently, it leaves it open to the State in which the permanent establishment is situated whether or not to give personal allowances and reliefs to the persons concerned in the proportion which the amount of the permanent establishment's profits bears to the world income taxable in the other State."* See also Part II, 2.D.III.D.
[1329] C-279/93, *Schumacker*, § 32-34.
[1330] C-279/93, *Schumacker*, § 37-38.

Since both justification grounds (the need to safeguard the cohesion of the tax system and the administrative difficulties preventing the work State from ascertaining the income earned by non-residents in their State of residence) were dismissed[1331], the ECJ held the measure to infringe the free movement of employees.

With respect to the second issue, the inapplicability of the adjustment procedures to non-residents, the conclusion was the same[1332]: given the disadvantage for non-residents and the lack of a valid justification, the measure was incompatible with EU law.

Commentary

Schumacker was a milestone. As will become apparent below, it paved the way for a string of cases which are all applications of the same line of reasoning. For the sake of clarity, this reasoning can be summarized as follows:

- In relation to direct taxes, the situations of residents and of non-residents are not, as a rule, comparable. The reason for this incomparability is of a two-fold nature:
  - A non-resident usually earns only a minor part of his income in the source State, whereas most of his income arises in his State of residence
  - A non-resident's personal ability to pay tax, determined by reference to his aggregate income and his personal and family circumstances, is more easy to assess at the place where his personal and financial interests are centred (i.e. his State of residence).
- As a result, it is generally up to the State of residence to take account of a taxpayer's personal and family circumstances

- The position is different if the non-resident receives no significant income in his State of residence and obtains the major part of his taxable income in the work State, with the result that his State of residence is not in a position to grant him the benefits resulting from the taking into account of his personal and family circumstances.
  - In such a case, the work State should take the personal and family circumstances of the non-resident into account in the same way as those of resident nationals and should grant the same tax benefits.

Looking over the structure of this reasoning, one would expect the two-fold nature of the argument for incomparability to be present in the *a contrario* argument for comparability as well, but this is not the case. More specifically, when the ECJ argues that residents and non-residents cannot be compared because of two reasons (i.e. a non-resident generally earns the major part of his income in his State of residence and his personal ability to pay tax is more easy to assess in that State), it would seem logical to follow the same line in the *a contrario* argument. However, the Court restricts itself to inverting the first reason for incomparability: the position is different if the non-resident earns most of his income in the State of employment. No mention is made of the second argument, the capability to assess the non-residents' ability to pay tax. However, this ability to pay tax is partly determined by reference to the taxpayer's aggregate income, which entails that the second reason for incomparability

[1331] C-279/93, *Schumacker*, § 40-47.
[1332] On this point, see also 2.E.I.B.g.2.

is (at least in part) implied in the first[1333]. Therefore, if the major part of the taxpayer's income is earned in the State of employment, it also becomes easier to assess the taxpayer's ability to pay tax in that State.

There is another element of asymmety in this structure. The Court states that the incomparability can partly be explained by the ease with which the State of residence can assess the taxpayer's personal ability to pay tax. One element of this ability to pay tax concerns the taxpayer's personal and family circumstances. On the other hand, when the situations are comparable, the Court holds that the fundamental freedoms require the State of employment to take the personal and family circumstances of the non-resident into account. However, no mention is made of the other elements of the taxpayer's personal ability to pay tax. There are suggestions in the Court's more recent case law that the *Schumacker*-doctrine can be extended to all elements determining a non-resident's ability to pay tax (see 2.E.I.A.b.1.b).

The *Schumacker*-ruling has drawn severe criticism, notably because the Court took the **overall** tax treatment of the taxpayer into account. That is to say, in determining whether the taxpayer deserves equal treatment in the host State, his position in the home State is taken into account. This seems to be in contrast with the ECJ's normal approach of applying the non-discrimination test in isolation, i.e. by singling out the tax measure at issue, without interference from other measures in that State or from the tax laws of other States[1334].

Another fundamental issue is that the comparability in *Schumacker* was determined on **factual** grounds, whereas the ECJ traditional examines the **legal** situation when assessing comparability. For instance, in *Avoir fiscal*, the Court considered the situations to be comparable because French tax law placed them on the same footing[1335]. The idea that the legal situation of the relevant categories determines their comparability can be found time and again in the Court's case law[1336]. In *Schumacker*, on the other hand, the comparability was

[1333] On the other hand, the Court has traditionally examined administrative difficulties in the justification-test, rather than the comparability-test. Moreover, this justification-argument is generally dismissed by the Court (e.g. C-204/90, *Bachmann*, § 17-18; C-1/93, *Halliburton*, § 21-22; C-520/04, *Turpeinen*, § 35-37). It was even dismissed as a justification-ground in the *Schumacker*-judgment itself (*Schumacker*, § 43-45). It is therefore remarkable that the Court accepts the difficulty to assess the taxpayer's ability to pay as a reason for incomparability in *Schumacker*. Cf. also 2.E.I.A.b.7.b, on C-282/07, *Truck Center*.

[1334] However, this strict approach is mitigated by several tools, for instance the fiscal cohesion-justification, which allows the Court to consider the measure under scrutiny against the broader backdrop of the tax system surrounding the measure, making it possible to take account of the necessary balance of the legal fabric as a whole (cf. infra, 2.F.III.B).

[1335] C-270/83, *Avoir fiscal*, § 19-20: *"French tax law does not distinguish, for the purpose of determining the income liable to corporation tax, between companies having their registered office in France and branches and agencies situated in France of companies whose registered office is abroad. By virtue of article 209 of the Code General des Impôts, both are liable to taxation on profits made in undertakings carried on in France, to the exclusion of profits which are made abroad or which France is entitled to tax under the terms of a double-taxation agreement. Since the rules at issue place companies whose registered office is in France and branches and agencies situated in France of companies whose registered office is abroad on the same footing for the purposes of taxing their profits, those rules cannot, without giving rise to discrimination, treat them differently in regard to the grant of an advantage related to taxation, such as shareholders' tax credits. By treating the two forms of establishment in the same way for the purposes of taxing their profits, the French legislature has in fact admitted that there is no objective difference between their positions in regard to the detailed rules and conditions relating to that taxation which could justify different treatment."*

[1336] E.g. C-370/04, Test Claimants in Class IV of the ACT Group Litigation, § 68: *"once a Member State, unilaterally or by a convention, imposes a charge to income tax not only on resident shareholders but also on non-resident shareholders in respect of dividends which they receive from a resident company, the position of those non-resident shareholders becomes comparable to that of resident shareholders"*; C-11/07, *Eckelkamp*, 11 determined entirely on factual grounds, i.e. the place where the taxpayer's income is concentrated. The factual nature of this criterion has created a great deal of uncertainty. For instance, what does it mean when the Court refers to a non-resident who *"receives the major part of his income and almost all his family income in a Member State other than that of his residence"*? The 90% threshold which has been accepted in the Court's case law after *Schumacker* is – at the very least – a bit arbitrary[1337].

Nevertheless, the reason why the ECJ uses this factual criterion is understandable. As mentioned in Part I, non-discrimination in direct tax matters is ultimately based on the ability to pay-principle: taxpayers whose ability to pay is the same should bear the same tax burden. Assuming that income is an appropriate indicator of ability to pay, it is defensible to factor the place where a taxpayer's income is concentrated into the discrimination-analysis. However, it is incorrect to make the entire comparability-test dependent upon this criterion. A taxpayer's income (and the division of that income between different States) can be expressed in absolute, mathematical values, which makes it possible to compare that taxpayer to another, hypothetical taxpayer. The division of income is therefore a suitable tool for comparing ability to pay in two situations, but this does not mean that a non-resident taxpayer suddenly becomes comparable to a resident taxpayer because the majority of his income is earned in the source State.

In theory, a non-resident taxpayer is comparable to a resident taxpayer as regards ability to pay insofar as he earns income in the source State. A non-resident taxpayer who earns 25% of his income in the source State is comparable to a resident taxpayer earning 25% of his income in that State. Accordingly, that non-resident should receive 25% of the person-related benefits of the source State (assuming that the source State applies a proportionate reduction of the benefits to its residents earning income abroad; see 2.E.I.A.b.1.c). But that aspect of comparability is not reflected in the *Schumacker*-doctrine, which turns entirely on the factual assessment as to whether the taxpayer earns 'almost all' of his income in the work State.

Apart from these conceptual objections, the criterion that the non-resident must earn (almost) all his income in the work State causes significant problems when he works in several States. For instance, a taxpayer who is a resident of State A earns 40% of his income in State B, 40% in State C and 20% in State D. According to the *Schumacker*-reasoning, the host State is required to intervene, as the taxpayer earns the major part of his income in a Member State other than that of his residence. However, it is unclear which State should intervene. Any choice between States B, C and D would be arbitrary and lead to divergent results, depending on the legal systems at issue (see also *infra*, on *De Groot*).

September 2008, § 62-63: *"the Belgian legislation deems, in principle, both the heirs of resident persons and the heirs of persons who were non-resident at the time of death to be taxable persons for the purposes of collecting inheritance and/or transfer duties on immovable properties situated in Belgium. It is only in respect of the deduction of debts from the inheritance of non-residents that non-residents and residents are treated differently. Where national legislation places the heirs of a person who, at the time of death, had the status of resident and those of a person who, at the time of death, had the status of non-resident on the same footing for the purposes of taxing an inherited immovable property which is situated in the Member State concerned, that legislation cannot, without giving rise to discrimination, treat those heirs differently in the taxation of that property so far as concerns the deductibility of charges secured on it. By treating the inheritances of those two categories of persons in the same way (except in relation to the deduction of debts) for the purposes of taxing their inheritance, the national legislature has in fact admitted that there is no objective difference between them in regard to the detailed rules and conditions relating to that taxation which could justify different treatment."*

[1337] Cf. 2.E.I.A.b.1.c.

Despite this criticism, the Court has not given up on *Schumacker*. On the contrary, the approach has been confirmed and even extended in later judgments (which will be discussed below). *Turpeinen*, for instance, illustrates that the requirement that the rules must be aimed at taking into account personal and family circumstances has been watered-down significantly.

2. Wielockx

Mr Wielockx was a Belgian national who resided in Belgium. He exercised a self-employed activity in the Netherlands, where he earned his entire income. Under the Belgian/Dutch tax treaty, Wielockx' income was exclusively taxable in the Netherlands. In the Netherlands, a different regime applied to resident and non-resident taxpayers. Resident self-employed taxpayers were able to allocate a portion of the profits of their business to form a pension reserve. These allocations were deductible from their taxable income. Non-resident self-employed taxpayers were unable to benefit from this pension-reserve tax scheme. Pursuant to a ministerial circular, non-residents could deduct personal commitments and extraordinary charges if at least 90% of their worldwide income was subject to tax in the Netherlands, but the circular did not cover pension reserves. The question arose whether this distinction was compatible with the freedom of establishment.

The ECJ first recalled its *Schumacker*-reasoning, that in relation to direct taxes, the situations of residents and of non-residents are not generally comparable, since there are objective differences between them from the point of view of the source of the income and the possibility of taking account of their ability to pay tax or their personal and family circumstances. Consequently, a difference in treatment between those categories can in itself not be discriminatory. However, a non-resident taxpayer, whether employed or self-employed, who receives all or almost all of his income in the State where he works is comparable to a resident of that State who does the same work there. If a non-resident taxpayer is not given the same tax treatment as regards deductions from his taxable income as a resident, his personal situation will be taken into account neither by the work State (because he does not reside there) nor by the State of residence (because he receives no income there). Consequently his overall tax burden will be greater and he will be at a disadvantage compared to a resident. Therefore, it would be discriminatory to deny a taxpayer earning (almost) all of his income in the work State the possibility to set up a pension reserve qualifying for deductions under the same conditions as a resident[1338].

Accordingly, the national rule denying non-residents the possibility to deduct pension contributions under the same conditions as residents constituted an unjustified discrimination. The Court thus extended the *Schumacker*-doctrine to self-employed persons.

3. Asscher

Mr Asscher was a national of the Netherlands who resided in Belgium. In the Netherlands, he was the director of a company, of which he was the only shareholder. Under the Belgian/Dutch tax treaty, Mr Asscher's remuneration received from the company in the Netherlands was exclusively taxable in the Netherlands. The remainder of his income was taxable in Belgium. The income earned in the Netherlands was exempt from tax in Belgium but Belgium was entitled to take the exempt income into account when determining the rate of tax and thus apply progressive taxation. The Dutch Income Tax Law applied a higher tax rate

[1338] C-80/94, *Wielockx*, § 18-22.

to income earned by non-residents than to income earned by residents or by non-residents treated as residents. Non-residents were treated as residents when all or almost all (i.e. at least 90%) of their worldwide income was taxable in the Netherlands. That condition was deemed to be fulfilled if the non-resident was subject in the Netherlands to contributions under the national compulsory social insurance scheme. Since Mr Asscher earned less than 90% of his worldwide income in the Netherlands, he did not meet the conditions required to be treated as a resident.

Until 1 January 1990, a taxpayer in Mr Asscher's position, who was not obliged to pay national insurance contributions (a 'non-contributing taxpayer'), paid wage and income tax at the same rate as a taxpayer who had to pay such contributions (a 'contributing taxpayer'), but the latter could deduct the contributions from the amount on which the tax was assessed. When, in 1990, the tax rates applicable to contributing taxpayers were lowered, that benefit was offset by withdrawal of the entitlement to deduct national insurance contributions from the taxable amount. Non-contributing taxpayers, however, were not affected by that withdrawal. For that reason, the tax rate applicable to non-contributing taxpayers was not lowered. Mr Asscher argued that the application of the higher rate to non-contributing taxpayers constituted indirect discrimination[1339].

The first issue to be addressed was whether Mr Asscher, being a national of the Netherlands, could invoke the relevant Treaty provisions against his State of origin, on whose territory he pursues an economic activity. In this regard, the ECJ remarks that, although the provisions of the Treaty on the freedom of establishment cannot be applied to situations which are purely internal to a Member State, they nevertheless cannot be interpreted in such a way as to exclude a Member State's own nationals from the benefit of EU law where by reason of their conduct they are, with regard to their Member State of origin, in a situation which may be regarded as equivalent to that of any other person enjoying the rights and liberties guaranteed by the Treaty (see supra, *Knoors, Bouchoucha, Kraus,* etc.). As Mr Asscher first pursued an economic activity in Belgium while residing in the Netherlands and subsequently transferred his residence to Belgium while pursuing economic activities at the same time in Belgium and the Netherlands, he was entitled to rely on the relevant Treaty provisions[1340].

The second and most important issue was whether the Dutch legislation violated the freedom of establishment by applying a higher tax rate to non-residents who pursue an activity as a self-employed person in the Netherlands and at the same time pursues another activity as a self-employed person in his State of residence than that applicable to residents pursuing the same activity. In addition, the question arose whether that issue was affected by the fact that less than 90% of the taxpayer's worldwide income could be taxed in the Netherlands.

The ECJ starts its analysis by repeating the standard formula that *"although direct taxation falls within the competence of the Member States, the latter must none the less exercise that competence consistently with Community law and therefore avoid any overt or covert discrimination by reason of nationality"*. Even though the Dutch legislation at issue applied

[1339] Mr Asscher relied on the free movement of workers, but the ECJ rephrased the issue as a matter of freedom of establishment, because of the nature of Asscher's activity as a self-employed person. However, the ECJ immediately adds that both provisions are based on the same principles as regards entry into and residence in the territory of the Member States and as regards the prohibition of discrimination on grounds of nationality, which implies that the same conclusion would be reached under both provisions (C-107/94, 27 June 1996, *Asscher*, § 25-29).
[1340] C-107/94, 27 June 1996, *Asscher*, § 33.

irrespective of nationality, it was liable to act mainly to the detriment of nationals of other Member States as it laid down a distinction founded on residence, and non-residents are most frequently non-nationals. Furthermore, in addition to the residence criterion, the legislation applied a threshold of at least 90% of worldwide income originating in the Netherlands, which meant that it was all the more likely to affect non-nationals.

The ECJ then recalls its *Schumacker*-doctrine (see supra)[1341]. Yet, even though Mr Asscher did not earn (almost) all of his income in the Netherlands, the ECJ considered the Dutch rules to constitute discrimination[1342]. This implies that the *Schumacker*-doctrine does not apply to a difference in treatment as regards tax rates. Unlike the personal benefits at issue in *Schumacker*, the tax rate as such does not reflect the taxpayer's ability to pay tax. Put differently, *Schumacker* was based on the assumption that a non-resident's ability to pay tax differs from that of a resident, since the former's income is generally concentrated in his home State (see supra). As a result, tax benefits taking account of the non-resident's ability to pay tax (e.g. personal allowances) must only be granted in the source State when the non-resident is comparable to a resident, i.e. when he earns almost all of his income there. But that does not apply with respect to the tax rate. Simply applying a higher tax rate to non-residents cannot be said to reflect a difference in ability to pay between both categories of taxpayers.

The Dutch government submitted two arguments concerning the disadvantage test: first, that the higher rate applicable to non-residents was intended to offset the fact that certain non-residents escaped progressive taxation because their tax rate was calculated on the basis of only their source income and, secondly, that the higher rate was intended to avoid that the tax burden on non-resident, non-contributing taxpayers was lighter than the tax burden on resident taxpayers. These arguments will be discussed in 2.E.I.B.c.5.

4. Gilly

Mr and Mrs Gilly resided in France, near the German border. Mr Gilly was a French national, Mrs Gilly was a German national, but she also obtained French nationality by reason of her marriage to Mr Gilly. Mrs Gilly taught at a school in Germany in the frontier area and earned 55% of the household's aggregate income[1343]. Art. 14(1) of the tax treaty between France and Germany (which is comparable to Art. 19 OECD MC) provided that salaries, wages and similar remuneration paid by one of the contracting States to individuals who were residents of the other State in respect of administrative services (including teaching services), were taxable only in the paying State. The second sentence of Art. 14(1) contained an exception to that rule, under which remuneration paid to a person having the nationality of the State of residence without being at the same time a national of the paying State was taxable in the State of residence.

Art. 20 of the treaty, the relief provision, provided that income arising in Germany and taxable there in accordance with the treaty provisions, was also taxable in France if derived by a resident of France. However, the recipient was entitled to a tax credit against the French tax in the base of which such income was included. With respect to income referred to in Art. 14, the amount of the credit was equal to the amount of French tax attributable to such income. As a result, Mrs Gilly was unable to set off the entire tax paid in Germany, because the tax scale in Germany was more progressive than the tax scale in France. France was unwilling to

[1341] C-107/94, 27 June 1996, *Asscher,* § 36-43.
[1342] C-107/94, 27 June 1996, *Asscher,* § 49.
[1343] Cf. Opinion of Advocate-General Colomer in C-336/96, *Gilly*, 20 November 1997, § 20.

give a higher credit than the amount of tax it levied itself because, otherwise, it would be refunding foreign tax.

Mrs Gilly argued that she was being discriminated against, as she was being taxed less favourably than a similar taxpayer exercising the same activities in France. According to Mrs Gilly, France should pay the difference between the German and French level of taxation in order to grant her the same tax treatment as a similar taxpayer exercising the same activity in France (i.e. in order to be effectively taxed according to the French rules).

The bulk of the *Gilly*-judgment was concerned the difference in treatment caused by the allocation of taxing powers under Article 14 of the treaty and the partial double taxation which remains despite the credit mechanism of Article 20 due to the different tax rates applicable in France and Germany. These issues will be discussed in 2.E.II.C.a.

The issue that is important here concerns Mrs Gilly's personal and family circumstances. As those circumstances were not taken into account when calculating the tax on her income from employment in Germany[1344], whereas they were taken into account in the calculation of the tax payable in France, the tax credit she received in France was lower than the tax actually paid in Germany. In this respect, the ECJ pointed out that *"the disparity derives from the fact that, in relation to direct taxes, the situations of residents and of non-residents are not, as a rule, comparable, since income received in the territory of a State by a non-resident is in most cases only a part of his total income, which is concentrated at his place of residence"*[1345]. According to the ECJ, this observation applied to Mrs Gilly's situation as well: even though her employment income was earned in Germany, it was aggregated with the taxable basis for assessing the income tax payable by her tax household in France, where she was therefore entitled to the tax advantages, rebates and deductions provided for in the French legislation. The German tax authorities were therefore not obliged to take account of her personal and family circumstances in such a situation.

Commentary

At first sight, *Gilly* seems difficult to reconcile with *Schumacker*. In fact, both cases were quite similar as to the relevant facts and both were identical in the method of relieving double taxation of the German income[1346]. The most important difference between both cases seems to be that Mr Schumacker went to Court in the host State (Germany), whereas Mrs Gilly initiated proceedings against her home State (France). Moreover, in *Schumacker*, the German

[1344] In particular, the German 'Splittingtarif' (see supra, on *Schumacker*) was not applied to Mrs Gilly because her spouse did not reside in Germany. Following *Schumacker*, the regime was made applicable to non-residents earning more than 90% of the aggregate income in Germany.
[1345] C-336/96, *Gilly*, § 49, referring to *Schumacker*.
[1346] Even though the treaty Article at issue in *Gilly* described the relief method as a 'credit', it was not a tax credit in the traditional definition: instead of crediting the German tax in France, the amount credited in France was the amount of French tax attributable to the foreign-source income. This method is sometimes referred to as 'alternative exemption' as it leads to the same result as the exemption-method. Under a credit system, if the tax paid in the source State is higher than the residence State tax, the difference is paid in the residence State, so that the taxpayer ultimately pays the higher of the two taxes. Under an exemption system, the taxpayer pays the source State tax (whether higher or lower than the residence State tax) and pays no tax on the foreign income in the residence State, so that the taxpayer ultimately pays the source State tax. Under the system of the French/German treaty, the taxpayer paid no French tax on the German income, regardless of whether the German tax rate was higher or lower than the French rate. Consequently, the result was the same as exemption. What France did in *Gilly* was actually identical to what Belgium did in *Schumacker*. Cf. J. AVERY JONES, "What is the difference between Schumacker and Gilly", *British Tax Review* 1999, 12.

domestic rules were at issue, whereas in *Gilly* the Court was asked to rule on the compatibility of the tax treaty with EU law[1347]. It seems that Mrs Gilly would have been more succesful by initiating proceedings in Germany against the German tax regime[1348].

However, there is another important difference which might explain the different outcome: Mrs Gilly's spouse earned income in their State of residence, whereas Mr Schumacker's wages were the household's sole income. The State of residence in both cases (i.e. Belgium and France) taxed spouses jointly, but in Belgium the tax on each spouse's earned income was calculated separately. Under the French system, the income of the two spouses was aggregated, then halved. The tax was then calculated, and finally doubled. The proportion of the resulting tax corresponding to the proportion of Mrs Gilly's German income in the joint income (55%) was then exempted. Allowances were given in calculating the income before aggregating it or after calculating the resulting tax. The result of this calculation for Mrs Gilly was that she enjoyed 45% of her allowances. Accordingly, if Mrs Gilly's spouse had not earned any income, the entire household income would have been exempt in France and Mrs Gilly would not have enjoyed any allowances. Similarly, if the Belgian system had been applied, i.e. if the tax on earned income of the spouses had been calculated separately, Mrs Gilly's entire income would have been exempt and she would have received no allowances either.

These two differences are not so obvious because they happened to coincide: Mr Schumacker's spouse had no earned income **and** Belgium calculated the rates on spouses' income separately, while Mrs Gilly's spouse did have some earned income **and** France did not calculate the rates separately. Because these aspects both lead to the same result, it might not be so obvious that there are actually two differences between *Gilly* and *Schumacker*. However, it should be noted that, in the first year at issue, Mr Schumacker's spouse drew unemployment benefit, which was taxed as earned income. In the second year at issue, Mr Schumacker's spouse did not have any earned income. Under Belgian tax law at the time, 30% of Mr Schumacker's earned income (with a fixed maximum) was attributed to her in order to alleviate the effect of progressivity[1349]. In other words, Mr Schumacker's spouse did have some earned income. In this respect, the situation was the same as that of Mrs Gilly. However, the reason why Mr Schumacker did not enjoy any benefit was the separate calculation of the tax due on each spouse's earned income: ultimately, the joint income was exempt in Belgium in both their hands because it arose in Germany. Whether or not Mrs Schumacker had any earned income, the result was the same for Mr Schumacker.

[1347] K. EICKER, "Tax treaties and EC law: Comment on the Gilly case", *European Taxation* 1998, 325-326.
[1348] Mrs Gilly complained that she lost 55% of her personal allowances in France. However, as will become apparent in 2.E.I.A.b.1.c, a home State is not breaching the fundamental freedoms when it restricts personal allowances on a pro rata basis to the domestic income earned by the taxpayer, as France did in *Gilly*. Therefore, it could be argued that Mrs Gilly was barking up the wrong tree and should have complained to the German authorities instead. However, the Court observes in *Gilly*, § 50 that, under the *Schumacker*-rule, the German tax authorities were not obliged to take account of Mrs Gilly's personal and family circumstances. As mentioned before, the discrimination in *Schumacker* arose if the non-resident received no significant income in his State of residence and obtained the major part of his family income from an activity performed in the State of employment, with the result that his State of residence was not in a position to grant him the benefits resulting from the taking into account of his personal and family circumstances. As Mrs Gilly's spouse earned 45% of the family income in France, the first part of the condition was not fulfilled. However, the result was the same. Under the French system, the personal situation of the couple was only taken into account in France to the extent of the income of the husband, i.e. 45%. The State of residence thus did not take account of Mrs Gilly's personal and family circumstances.
[1349] Art. 87 Income Tax Code.

What is perhaps most surprising about the *Gilly*-judgment is the Court's observation in § 49 that the double taxation resulting from the personal circumstances being taken into account in France but not in Germany is a *disparity* resulting from the *Schumacker*-incomparability. It is understandable that the Court attributes the disadvantage incurred by reason of the different tax rates in France and Germany to a disparity (see 2.E.II), but it is unclear why the ECJ held that the aspect of the disadvantage relating to personal circumstances was also the result of a disparity. Assuming that the Court's general idea was that Mrs Gilly should be litigating against Germany instead of France, it could have done so without referring to a disparity.

The reason for this remarkable choice of words can most likely be found in the Advocate-General's opinion in *Gilly*, who observes that the relief provision is not contrary to EU law, because if Germany were simply to reduce its tax rate on income from employment to a rate lower than the French rate (or if France were to increase its rate of tax on such income to a rate higher than the German rate), *"the procedure which is now criticised for adversely affecting workers exercising their freedom of movement would have the opposite effect."* In particular, if the German rate were lower than the French rate, with Mrs Gilly receiving a tax credit equal to the amount of the French tax on the relevant income, the tax credit would be greater than the tax already paid in Germany and she would end up by paying less tax on that income than if she had received it in France. The Advocate-General thus concludes: *"whether the consequences of a provision such as that in question here are unfavourable to workers depends, in the final analysis, on the tax rates charged in each Member State on certain income and I therefore consider that those consequences are too uncertain and indirect for the provision to be regarded as being capable of deterring a worker from exercising his or her freedom of movement between the two Member States in question"*[1350].

Put briefly, the Advocate-General argues that the disadvantage is solely due to the difference in tax rates. If the tax rates were harmonized, the disadvantage would therefore disappear. The ECJ followed suit, and held that the disadvantage was *"the result in the first place of the differences between the tax scales of the Member States concerned, and, in the absence of any Community legislation in the field, the determination of those scales is a matter for the Member States"*[1351]. However, a calculation shows that this argument is not entirely correct.

Assuming that Mr and Mrs Gilly's household income was 300,000 FRF, Mrs Gilly earned 165,000 in Germany and Mr Gilly earned 135,000 in France[1352]. At the material time, the

[1350] Opinion of Advocate-General Colomer in C-336/96, *Gilly*, 20 November 1997, § 61. The terminology of consequences that are 'too uncertain and indirect' stems from case law on the free movement of goods such as C-69/88, *Krantz*, 7 March 1990, § 11 and C-379/92, *Peralta*, 14 July 1994, § 24. As mentioned earlier, the ECJ has narrowed the effects of *Dassonville* in *Keck and Mithouard*, by excluding all national provisions on methods of sale without discriminatory effects from the scope of the *Dassonville*-definition of measures having equivalent effect. The idea underlying *Keck and Mithouard*, that provisions on selling arrangements only have a minimal impact, also underlies these judgments in which certain restrictions on the trade in goods are considered too undertain and indirect to hinder intra-EU trade (see K. LENAERTS and P. VAN NUFFEL, *Constitutional law of the European Union*, London, Sweet & Maxwell, 1999, 132. However, that case law does not seem very relevant to the present discussion. When there is a disparity, it is irrelevant whether the disadvantage is uncertain or indirect: it falls outside the scope of the treaty freedoms irrespective of the extent of the disadvantage. Moreover, it is difficult to see why the disadvantage incurred by the Gillys is uncertain or indirect. The calculation made here shows that it is very certain and very direct.

[1351] C-336/96, *Gilly*, § 47.

[1352] The calculation is taken from P. WATTEL, "Progressive taxation of non-residents and intra-EC allocation of personal tax allowances: why Schumacker, Asscher, Gilly and Gschwind do not suffice", *European Taxation* 2000, 220. It is unclear from the ECJ's judgment what the Gillys' exact income was. The Advocate-General does family's basic allowance in France was 25,890. The tax rates on the amount exceeding the basic allowance were as follows:

Taxable income	Rate
25,890 – 50,930	10.5%
50,930 – 89,650	24%
89,650 – 145,160	33%
145,160 – 236,290	43%

Under the French splitting mechanism, the net family income was halved. The tax was then calculated on the resulting halved net income, after which the amount of tax was doubled (cf. supra). Accordingly, the tax due in France on the net worldwide income of 300,000 was 64,643.

The German tax due on Mrs Gilly's income was 39,669. The Gillys were not entitled to splitting in Germany.

The relief for double taxation in France was calculated as follows:

$$\text{Relief} = \text{French tax on worldwide income} \times \frac{\text{net income taxed in Germany}}{\text{net worldwide income}}$$

In the case of the Gillys, this amounts to 35,553.65 (i.e. 64,643 x 0.55).

The calculation is therefore as follows:

Net worldwide income	=	300,000
Tax due in France	=	64,643
Income taxed in Germany	=	165,000
Tax due in Germany	=	39,669
Total tax due	=	104,312
Relief given by France	=	35,554
Total tax due after relief	=	68,758

In other words, if only France had taxed (i.e. if the entire household income had been earned in France), the total tax due would decrease by 4,115. This amount is the disadvantage incurred by the Gillys because Mrs Gilly works in another Member State.

If the French and German tax rates and progression were harmonized, the calculation would have been as follows:

Net worldwide income	=	300,000
Tax due in France	=	64,643
Income taxed in Germany	=	165,000
Tax due in Germany	=	38,772

mention in § 20 of his opinion that Mr Gilly earned approximately 45% (135,000 in the example) of the family income in France while Mrs Gilly earned approximately 55% (165,000 in the example) in Germany.

Total tax due	=	103,415
Relief given by France	=	35,554
Total tax due after relief	=	67,861

Even if the tax rates were harmonized, there would still be a disadvantage of 3,218 (i.e. the excess above the amount of tax which would have been due if only France had taxed). Consequently, the disadvantage is not entirely due to the divergent tax rates. Admittedly, the disadvantage decreases somewhat in the second calculation, but does not disappear entirely. The fraction of the disadvantage that would disappear if the rates in France and Germany had been identical (897) is the result of a disparity, which can only be removed by harmonizing the systems[1353].

However, the remainder of the disadvantage (3,218) is not due to the differences between the tax scales in France and Germany. Instead, it is caused by the fact that France, as the State of residence, does not take Mrs Gilly's personal and family circumstances entirely into account while Germany, as the work State, does not grant any benefits relating to these circumstances. It is therefore incorrect to assume that the entire disadvantage incurred by the Gillys by reason of Mrs Gilly's cross-border activity is due to a disparity[1354].

Furthermore, if the Gillys had been entitled in France to personal allowances and deductions, the disadvantage would be even greater. For instance, if they had personal expenses of 50,000, the calculation would be as follows:

Net worldwide income	=	250,000
Tax due in France	=	47,175
Income taxed in Germany	=	165,000
Tax due in Germany	=	39,669
Total tax due	=	86,844
Relief given by France	=	25,946
Total tax due after relief	=	60,898

The disadvantage incurred by reason of Mrs Gilly's cross-border activity would therefore be 13,723. The fraction of this disadvantage resulting from the divergent tax rates (i.e. the actual

1353 See 2.E.II. Obviously, the divergent tax rates might be beneficial for the taxpayer in some cases, particularly for residents of exemption States where the tax rates in the State of residence are higher than the rates of the work State.

1354 Apart from suggesting that the disadvantage would be removed if the tax rates were harmonized, the Advocate-General also assumes that the Gillys would have received an advantage if the German rates had been lower than the French rates. This is assumption is not entirely correct either. Under the French tax rates described above, the French tax that would have to be paid on the income of 165,000 is 38,711.5. This is an average tax rate of 23.5%. Assuming that the German rates were lower than the French rates, for instance amounting to an average tax rate of 23%, the German tax due on 165,000 would be 37,950. Applying the same calculation as carried out earlier demonstrates that the Gillys would still pay 2,396 more tax than in the situation where only France had taxed the income (tax due in France = 64,643; tax due in Germany = 37,950; relief in France = 35,554, total tax due after relief = 67,039). Once again, the disadvantage would decrease, but it would not disappear completely. In order for the disadvantage to turn into an advantage, the tax due in Germany has to be lower than the relief granted in France. Accordingly, the average tax rate in Germany on 165,000 would have to be lower than 21,548%.

disparity) is still 897[1355]. The significant increase in the disadvantage is due to the allocation of 55% of the French person-related benefits to the income taxed in Germany. Because Mrs Gilly earns 55% of the household income in Germany, 55% of the personal deductions and allowances are allocated to the German-sourced income[1356].

As will become apparent below, it is not problematic for home States to deny their residents a part of the person-related benefits in proportion to the amount of income earned abroad. What is problematic from a non-discrimination perspective, however, is that the work State entirely refuses non-residents to enjoy its own regime of person-related benefits. Of course, the end result depends on the work State's specific regime, even if that regime is not discriminatory. Accordingly, it is possible that the disadvantage still persists to some extent, but the ultimate objective of non-discrimination is not to ensure full neutrality as compared to the purely domestic situation, but rather to ensure the same treatment as comparable residents or nationals of the work State.

5. Gschwind

Mr Gschwind, a national of the Netherlands who lived with his spouse in the Netherlands, was employed in Germany while his spouse was employed in the Netherlands. Mr Gschwind earned DEM 74,000 in Germany, which represented 58% of the household's aggregate income. Under the Dutch/German tax treaty, Mr Gschwind's income was taxable in Germany, while his spouse's income was taxable in the Netherlands. The tax treaty further allowed the Dutch tax authorities to incude in the tax base the income taxable in Germany, while deducting from the tax so calculated the part of it corresponding to the taxable income in Germany.

German income tax law applied different rules to residents and non-residents. Residents were subject to tax on their worldwide income, while non-residents were taxable only on the part of their income arising in Germany. Married residents who were not permanently separated enjoyed the beneficial 'splitting tariff' to mitigate the progressive nature of the income tax scale (cf. supra, on *Schumacker*). This favourable tax treatment was originally restricted to spouses who resided in Germany. After the *Schumacker*- and *Wielockx*-cases, the German legislation was amended. Since that amendment, a married non-resident who was a national of an EU or EEA Member State could apply for joint assessment under the splitting procedure, if his spouse resided in one of those States and at least 90% of the total income of the spouse was subject to German income tax or their income not so subject did not exceed DEM 24,000 in the calendar year. In those circumstances, although the spouses were non-residents in Germany, German law treated them as being subject to unlimited taxation. As such, they were entitled to the other tax concessions accorded to residents to take account of their personal and family circumstances.

[1355] Assuming that the tax rates were harmonized, the tax due after relief would be 60,001, which means that the disadvantage would decrease by 897.

[1356] The disadvantage is the difference between the total tax due after relief and the tax due in France on the worldwide income. In the first example, the disadvantage was (64,643 + 39,669) – (64,643 x 0.55) – 64,643 = 4,115.35. When there are personal expenses of 50,000, the disadvantage is (47,175 + 39,669) – (47,175 x 0.55) – 47,175 = 13,722.75. The disadvantage therefore increases by 9,607.4. This can be explained by the French relief system, which effectively allocates 55% of the benefits to the German income. Put briefly, the relief mechanism exempts a proportion of the home State tax on the worldwide income, corresponding to the proportion of the income earned abroad, thereby exempting the same proportion of the allowances (i.e. 55% in the *Gilly*-case).

The German tax authorities assessed Mr Gschwind to income tax as a person subject to unlimited taxation but treated him as if he were single, on the ground that the income received by his spouse in the Netherlands exceeded both the absolute threshold of DEM 24,000 per year and the relative threshold of 10% of the household's aggregated income. That assessment entailed for Mr Gschwind an additional tax charge compared with the tax which he would have paid under the scale applicable to married couples under the splitting procedure. The question arose whether this gave rise a violation of the free movement of workers.

The German government argued that the German legislature had drawn the appropriate inferences from the *Schumacker*-judgment in making the applicability of the splitting procedure to non-residents subject to the absolute threshold of DEM 24,000 per year or the relative threshold of 10% of the household's aggregate income. According to the German government, the *Schumacker*-judgment required non-residents to be granted the benefit of the splitting procedure only if their personal and family circumstances could not be taken into account in their State of residence because they earned their main income and almost all their family income in Germany. By contrast, in situations such as that of Mr Gschwind, in which a significant part of the family revenue is earned in the taxpayer's State of residence, that State is in a position to grant the concessions, provided for in its legislation, which arise from having his personal and family circumstances taken into account.

The Commission disagreed and submitted that, since the State of residence (the Netherlands) had waived taxation of Mr Gschwind's employment income under a tax treaty, only the work State was in a position to take his personal and family circumstances into consideration. Furthermore, the Commission argued that a taxpayer would opt for splitting only in the State in which the spouse who earned the most income was taxed because that would be the only way that splitting would mitigate the progressivity of the tax scale. Consequently, splitting could not lead to double tax relief due to the taxpayer's family circumstances in both the State of residence and the work State. Moreover, the Commission argued that the Gschwinds' situation was objectively comparable to that of a couple residing in Germany one of whom receives, in another Member State, employment income exempt from German tax under a tax treaty but to whom the German legislature allows the splitting arrangement to be applied.

Finally, the Commission commented on the German government's interpretation of *Schumacker*. The Commission contested the position that, under the *Schumacker*-judgment, Germany could take account of both spouses' income to ensure that the income thresholds are observed. As German tax was charged only on Mr Gschwind's income to which the spouse's income was added solely in order to take account of tax progressivity and not in order to tax that income as well, the Commission was doubtful whether it was consistent to take account of both spouses' income in order to assess whether the 90% threshold was reached.

The ECJ first paraphrased its *Schumacker*-doctrine on comparability (see supra). However, there is a clear difference between Mr Gschwind's situation and Mr Schumacker's situation. Mr Schumacker's income formed almost the entire income of his tax household and neither he nor his spouse had any significant income in their State of residence allowing account to be taken of their personal and family circumstances. In Gschwind's case, by laying down a percentage threshold and an absolute threshold, the German legislation took account specifically of the possibility of taking into consideration, on a sufficient tax base, the personal and family circumstances of taxpayers in the State of residence. As nearly 42% of the Gschwinds' income was earned in their State of residence, that State was in a position to take Mr Gschwind's personal and family circumstances into account according to its domestic rules, since the tax base was sufficient there to do so.

The ECJ therefore concluded that it was not established that *"for the application of tax provisions such as those in question in the main proceedings, a non-resident married couple of whom one spouse works in the State of taxation in question and who may, owing to the existence of a sufficient tax base in the State of residence, have his personal and family circumstances taken into account by the tax authorities of that latter State is in a situation comparable to that of a resident married couple, even if one of the spouses works in another Member State."*

Finally, with regard to the Commission's argument that, for the purposes of determining the thresholds, it was not consistent to take account of both spouses' income, the ECJ held that *"although the person subject to the tax of the State of employment is the individual and not the couple, a method of calculating the rate of taxation such as the splitting method is based by its nature on the practice of taking account of the income of each of the spouses."*

As a result, the German legislation did not violate the free movement of workers. Even though the facts of the case were similar to *Gilly*, the Court does not consider the disadvantage to result from a disparity (nor does it refer to *Gilly*, for that matter). Instead, the *Schumacker*-incomparability is applied, which means that no discrimination arises.

6. De Groot

Mr De Groot was a resident national of the Netherlands. Until 1 April 1994, he was employed in the Netherlands and in other Member States by companies established in the Netherlands, France, Germany and the U.K., belonging to the same group. His contract of employment with those companies ended on 1 April 1994. In 1994, 60% of his worldwide income was earned abroad. As he did not meet the 90%-threshold in any of the three work States, he was not entitled to person-related benefits in those States.

When his marriage was dissolved in 1987, Mr De Groot was obliged to make maintenance payments. In December 1994, he discharged that obligation by making a one-time payment. Such maintenance payments were deductible personal expenses in the Netherlands.

In the case of a resident taxpayer like Mr De Groot earning his income partly in the Netherlands and partly in another Member State, Dutch income tax legislation provided that the amount of tax due was calculated as follows. First, the progressive rate was applied to worldwide income, including exempt foreign income. Subsequently, maintenance payments and the tax-free allowance to which the taxpayer was entitled as a result of his personal or family circumstances were deducted. Finally, relief for double taxation was granted by way of a reduction of income tax. The amount of the reduction was calculated by multiplying the tax on the worldwide income by the 'proportionality factor', i.e. a fraction with the foreign gross income as the numerator and the worldwide gross income as the denominator. Maintenance payments made by the taxpayer and his tax-free allowance, which were taken into account in calculating the tax on the worldwide income, were not deducted from the gross worldwide income used as the denominator in the proportionality factor. The aim was to distribute the allowances relating to a taxpayer's personal and family circumstances over his total income. As a result, those allowances were deducted from the tax payable in the Netherlands only in proportion to the income received by the taxpayer in the Netherlands. Accordingly, the reduction granted to Mr De Groot was 60/100 of the tax the Netherlands would have levied on the worldwide income (reduced by the deductible maintenance payments). As a result, 60% of the personal benefits disappeared.

Under all three relevant tax treaties, i.e. the Dutch/French, the Dutch/German and the Dutch/U.K. treaty, the employment income was taxable in the work State. Under the relief provision in the Dutch/U.K. treaty, the Netherlands was required to exempt income which could be taxed in the U.K. by granting a reduction of the Dutch tax calculated in accordance with the provisions of national law on the avoidance of double taxation (i.e. by applying the proportionality factor). The treaties with France and Germany contained no reference to the domestic law of the Netherlands, but provided directly for the application of the proportionality factor in calculating the tax reduction in the Netherlands. Under all three treaties, the Netherlands applied the method of exemption subject to progressivity, as laid down in Art. 23A(1) and (3) OECD MC.

Mr De Groot argued that the use of the proportionality factor violated the free movement of workers because he lost part of the tax relief to which he should have been entitled on account of his personal circumstances. More specifically, his personal allowances (i.e. the allowance for the maintenance payments and the tax-free allowance) had no effect on the reduction to avoid double taxation. As his personal liabilities and personal and family circumstances were not taken into account in the levying of foreign tax, he received less tax relief on account of personal liabilities borne by him, and was able to take less advantage of the tax-free allowance, than would have been the case if he had derived his total employment income in 1994 exclusively in the Netherlands.

Before the ECJ, the Dutch government argued that the disadvantage incurred by Mr De Groot was solely the result of the application of the method of avoiding double taxation put in place by the tax treaties. Thus, when applying in the Netherlands the method of exemption with progression and calculating the tax reduction, certain personal allowances were deducted in proportion to the income exempt from tax in the Netherlands. The Dutch government, relying on *Gilly*, contended that the non-deductibility of those allowances in the State(s) of employment from the tax levied on the income received in those States resulted from the differences between the tax systems of the Member States, and was therefore not contrary to the free movement provisions.

The Dutch government argued that the issue could only be remedied if the State(s) of employment would grant the allowances relating to the taxpayer's personal and family circumstances in proportion to the income derived in those States. However, in accordance with *Schumacker*, the State of employment was required to grant those personal allowance only where the taxpayer earned (almost) all of his income in that State. Furthermore, since the allowances could not be attributed to any particular source of income, they had to be distributed over the whole of the income, with the result that the State of residence, the Netherlands, was correct in taking them into account only in proportion to the income derived in its territory[1357].

The ECJ first verified whether the disadvantage suffered by Mr De Groot was due to a disparity. In this regard, the ECJ held that the situation of Mr De Groot could be distinguished from that of *Gilly*, since the tax disadvantage suffered by Mr De Groot was not the result of

[1357] C-385/00, *De Groot*, § 59-60.

the difference between the tax rates of the State of residence and those of the States of employment. Moreover, while Mrs Gilly obtained in her State of residence all the tax advantages which were available to its residents by the legislation of that State, that was not the case with respect to Mr De Groot, whose claim was precisely that he was deprived in his State of residence of part of the reductions available to residents because he exercised his free movement.

The ECJ then referred to its *Schumacker*-position that the work State is only required to grant personal and family related tax allowances if the taxpayer derives (almost) all of his taxable income from employment in that State and has no significant income in his State of residence. It is in principle a matter for the residence State to grant those allowances because that State is best placed to assess the taxpayer's personal ability to pay tax.

In Mr De Groot's case, the maintenance payments and the tax-free allowance were taken into account in calculating the theoretical amount of tax payable on his worldwide income, but as a result of the application of the proportionality factor, he benefited from the benefits only in proportion to his domestic income. As a consequence of exercising his free movement right, he forfeited part of those allowances. Consequently, the ECJ considered the application of the proportionality factor to constitute an obstacle to the free movement of workers[1358].

Several justification grounds were put forward. First, it was argued that the disadvantage suffered by a taxpayer such as Mr De Groot was to a large extent compensated for by a progressivity advantage (i.e. the 'salary split': workers who are taxed in each State of employment only on part of their income are at an advantage as regards income tax progression). The ECJ dismissed this argument by referring to the settled case-law according to which detrimental tax treatment contrary to a fundamental freedom cannot be removed by other tax advantages (see 2.E.1.B.c).

Secondly, the balanced allocation of taxing powers was also rejected as a justification ground. The Dutch government had argued that it was legitimate for the residence State to take account of the personal and family circumstances of a resident taxpayer only in proportion to the income derived in its territory since the work State should do the same with respect to the share of income taxable in its territory. In that respect, the ECJ pointed out that income received in the territory of a Member State by a non-resident worker is in most cases only a part of his total income, which is concentrated at his place of residence. Therefore, it is easier for the residence State to assess the taxpayer's ability to pay tax.

In the absence of unifying or harmonising EU measures, the Member States remain free to alter the correlation between the total income of residents and their personal and family circumstances to be taken into account by the residence State. The residence State can therefore be released by way of a tax treaty from its obligation to fully take account of those circimstances of resident taxpayers who partially work abroad. The residence State may also be released from that obligation if it finds that, even in the absence of a tax treaty, one or more of the work States grant personal allowances to non-residents who receive taxable income there with respect to the income taxed by them.

[1358] It is difficult to reconcile the Court's conclusion in *De Groot*, that the State of residence is required to remove the disadvantage, with its decision in *Gilly*. The Court tries to distinguish *De Groot* from *Gilly* on the basis that the disadvantage in *Gilly* was due to a disparity and that Mrs Gilly obtained all the tax benefits in France. As mentioned in 2.E.I.A.b.1.a.4, however, the disadvantage in *Gilly* was not entirely due to a disparity and Mrs Gilly was not entitled to all tax benefits in France.

However, the Court stresses that taxpayers have to be certain that, as the end result, all their personal and family circumstances will be duly taken into account, irrespective of how those Member States have allocated that obligation amongst themselves. In *De Groot*, that result was not ensured by Dutch law and the treaties concluded with Germany, France and the U.K., since the residence State was partially released from its obligation to take into account the taxpayers' personal and family circumstances without the work States undertaking to do so or having this obligation imposed on them by virtue of the tax treaties concluded with the residence State[1359].

In conclusion, the ECJ held that the free movement of workers precludes rules – irrespective of whether or not they are laid down in a convention for the avoidance of double taxation – whereby a taxpayer forfeits part of the tax-free amount and of his personal tax advantages in the residence State because he also received income in another Member State which was taxed in that State without his personal and family circumstances being taken into account there.

Commentary

In other words, the residence State is not allowed to distribute the person-related benefits over the taxpayer's worldwide income. Instead, those benefits should be allocated entirely to the domestic income. In the proportionality factor used in *De Groot*, the allowances must therefore be deducted from the denominator of the fraction (i.e. the gross worldwide income), resulting in a higher amount of double taxation relief. This solution removes the disadvantage in most cases, and might even work in favour of taxpayers working abroad. An example will be given in 2.E.I.A.b.1.c.

While it is true that the disadvantage incurred by taxpayers such as Mr De Groot should be remedied in an internal market, it is submitted that the Court offered the wrong solution. From a logical and analytical perspective, the *De Groot*-judgment is entirely correct, but the problem is that it is based on an incorrect premise. In other words, the problem is not that the Court's reasoning in *De Groot* was incorrect, but rather that the reasoning was based on an incorrect starting point.

In *Schumacker*, the Court held that the work State is only required to grant its person-related benefits if the non-resident earns (almost) all his income in that State. Taxpayers working abroad incur a disadvantage if they do not meet that threshold. Therefore, it is up to the State of residence to remove the disadvantage. The State of residence is therefore prohibited from using the proportional method to calculate double taxation relief.

As will become apparent below, the *Schumacker*-premise is contrary to the principle of non-discrimination. A better solution was brought forward by the Dutch government in *De Groot*: it is up to the work State(s) to grant a part of their person-related benefits to non-resident, in proportion to the amount of income earned in their territory (insofar as they grant proportional benefits to their own residents). That solution tallies with the non-discrimination principle, as it ensures equal treatment of comparable residents and non-residents.

[1359] C-385/00, *De Groot*, § 98-102.

Interestingly, the Court suggests that the residence State could be released from its obligation to grant the benefits if one or more of the States of employment, with respect to the income taxed by them, grant personal allowances to non-residents who receive taxable income there[1360]. This is an application of the Court's so-called 'always somewhere' approach. Under that approach, it does not really matter to the Court where the benefits in question are granted, as long as they are granted. Clearly, that has little to do with non-discrimination. It is not because one State decides to grant a specific benefit that the regime of another State, which has been held discriminatory, is no longer discriminatory all of a sudden. Indeed, the Court has generally refused to take account of counterbalancing advantages in order to determine whether the disadvantage at issue may disappear (see 2.E.I.B).

In other words, the Dutch system at issue in *De Groot* was entirely compatible with the non-discrimination principle: residents working at home and residents working abroad were treated identically insofar as they were comparable. That is to say, personal benefits were granted in proportion to the amount of income earned in the Netherlands. And the amount of income eanred in a State is a relevant characteristic as regards a taxpayer's ability to pay tax (of which the taking into account of personal circumstances is an expression). Nevertheless, it is possible that a taxpayer working abroad still suffers a disadvantage as compared to a taxpayer working at home, but that would be due to the fact that the work State has a different system of taking personal circumstances into account. It is possible that the disadvantage is then due to discrimination by the work State (namely where that State distinguishes between residents and non-residents) but it may also be due to a disparity (namely where the work State simply never grants those benefits, neither to residents nor to non-residents, or where the work State grants lower benefits than the residence State).

Finally, the Belgian tax authorities' response to the ECJ's decision in *De Groot* was discussed in Part II, 2.D.III.D.d.

7. Gerritse

Mr Gerritse, a resident national of the Netherlands, received DEM 6,007.55 for performing as a drummer in Berlin. He incurred business expenses of DEM 968. In the same year, Gerritse also received gross income of DEM 55,000 in the Netherlands and in Belgium.

Under the German rules on the taxation of non-residents (i.e. persons subject to limited tax liability in Germany), the income tax on income from artistic performances was withheld at source at a rate of 25% of the income received. Business expenses could not be deducted, unless the expenses represented more than half of the income received. The German legislation also allowed certain non-residents to opt for the regime applicable to residents (i.e. persons subject to full tax liability in Germany). However, this option applied only if either at least 90 % of the income had been subject to German income tax during the calendar year, or the income not subject to German income tax during the calendar year was equal to or less than DEM 12,000. In the regime applicable to residents, the taxable base was the net profit after deduction of business expenses. In addition, a tax-free allowance of DEM 12,095 applied in that regime.

In accordance with the Dutch/German tax treaty, Gerritse's income from the artistic performance was taxable in Germany, where it was subject to the withholding tax of 25%.

[1360] C-385/00, *De Groot*, § 100.

Gerritse lodged a request with the German tax authorities to be treated as a person subject to full tax liability. However, the tax administration dismissed the request, as Gerritse's other income (i.e. not subject to German tax) exceeded the cap of DEM 12,000. The question arose whether the German legislation violated the freedom to provide services.

Two separate issues were identified by the ECJ. First, the German legislation took, as a general rule, gross income into account when taxing non-residents, without allowing for their business expenses to be deducted, whereas residents were taxed on their net income after deduction of their business expenses. Secondly, non-residents' income was subject to a final source withholding tax at a uniform rate of 25 %, whereas residents' income was taxed at a progressive scale, including a tax-free allowance. The first issue will be discussed in 2.E.I.A.b.2.b.

As to the second issue, the withholding tax of 25%, Gerritse argued that the deduction of tax at source combined with the inapplicability of the tax-free allowance in the case of non-residents, was incompatible with EU law, as its effect was to impose a minimum rate of tax on non-residents. The German authorities countered by arguing that *"deduction at source constitutes a legitimate and appropriate method for the tax treatment of a partially taxable person, established abroad."* Furthermore, if the regime applicable to German residents would be applied to Gerritse, he would escape the progressive element of the German income tax, even though his worldwide income required the application of a higher rate. This would mean that partially taxable taxpayers would be favoured in comparison to wholly taxable persons, for whom worldwide income was taken into account when determining the tax rate. Finally, Germany referred to the *Schumacker*-doctrine (i.e. that the obligation to take the taxpayer's personal situation into account is a matter for the State of residence, unless there is insufficient income in that State), holding that *"a tax-free allowance is designed to protect the essential minimum income of taxpayers with low incomes, which is in principle a matter falling within the responsibility of the State of residence, where, as a general rule, the taxpayer receives the greater part of his income. The German tax authorities take account of the essential minimum in the case of a partially taxable person, in so far as that person is subject to assessment in the ordinary way, where the income received abroad is less than DEM 12,000"*[1361]. In other words, it is in principle up to the State of residence, which takes the taxpayer's worldwide net income into account, to incorporate considerations of a social nature into its tax system, thereby, for instance, providing for a tax-free allowance[1362].

[1361] C-234/01, *Gerritse*, § 36.

[1362] An interesting argument was advanced by the Commission (*Gerritse*, § 38-41). The Commission proposes to calculate the 'average rate of taxation', which could serve as a reference for non-discriminatory treatment. More specifically, the Commission applies the German progressive rates to Gerritse's German income, without, however, applying the tax-free allowance (according to the Commission, the tax-free allowance should not be applied *"bearing in mind the circumstances of the case at issue"*). Adding the net income (6,007.55 – 968 = 5,039.55) to the tax-free allowance (12,095) results in a total of 17,134.55. If the progressive rates are applied to this total, a tax of 1,337 would be due. This corresponds to 26.5% of the net income. As this 'average tax rate' is close to the rate of 25% actually applied to Gerritse, the Commission argues that there is no discrimination. A clarification is welcome here. The Commission argues that the tax-free allowance should not be taken into account when calculating the 'average tax rate'. However, the inapplicability of the tax-free allowance was exactly an aspect of the discrimination, according to Gerritse. Therefore, it may seem debatable to disregard the tax-free allowance when devising a benchmark to test whether discrimination exists. However, the discrimination contested by Gerritse consisted of the distinction between residents and non-residents. Consequently, in order to assess whether the alleged discrimination exists, the benchmark should be a hypothetical resident in the same circumstances as Gerritse. Such a hypothetical resident would earn a net worldwide income of 55,000 + 5,039.55 = 60,039.55. As a result, the tax-free allowance of 12,095 has been exceeded. In order to assess the amount of tax burdening the fee for the artistic performance of the hypothetical

The ECJ starts its analysis by reiterating its *Schumacker*-doctrine. Furthermore, the ECJ refers to the OECD MC, which uses residence as a connecting factor for the purpose of allocating powers of taxation between States in situations involving extraneous elements[1363].

As Gerritse earned only a minimal part of his income in Germany, the question arose whether he was incomparable to a resident, with the result that the application of the final withholding tax would not give rise to discrimination. In that respect, the ECJ first considers the **tax-free allowance**, noting that *"since […] it has a social purpose, allowing the taxpayer to be granted an essential minimum exempt from all income tax, it is legitimate to reserve the grant of that advantage to persons who have received the greater part of their taxable income in the State of taxation, that is to say, as a general rule, residents"*[1364]. It is remarkable that the ECJ refers to the 'social purpose' of the measure, which renders it 'legitimate' to reserve the advantage to residents. Since Mr Gerritse was a non-resident earning only a minimal part of his income in Germany, it should be clear that he was incomparable to a German resident. Consequently, a justification-test would be unnecessary. The reason for this seemingly redundant detour will become apparent below.

The ECJ also notes that the second part of the *Schumacker*-doctrine is fulfilled by the German measure: if a non-resident would earn the greater part of his income in Germany (thereby meeting one of the two conditions of the German 'opt-in regime': either at least 90 % of the income had been subject to German income tax, or the other income was equal to or less than DEM 12,000), he would be taxed as a resident. Finally, in reply to a question by the Court, the Dutch government indicated that, in a case such as that of Mr Gerritse, the taxpayer could benefit in the Netherlands (the State of residence) from a tax-free allowance, to be deducted from his overall income. In other words, an advantage comparable to that claimed by Mr Gerritse in Germany was granted in his State of residence, which was required, in principle, take into account the personal and family situation of the person concerned.

As for the application of the **flat rate of 25%** to non-residents while residents were subject to a progressive rate, the ECJ indicates that the Netherlands as State of residence, pursuant to the tax treaty, applied the progressivity rule, i.e. integrated the income which was taxable in Germany into the basis of assessment. However, the Court noted that the Netherlands took account of the tax levied in Germany, *"by deducting from the Netherlands tax a fraction which corresponds to the relation between the income taxed in Germany and worldwide income. That means that, with regard to the progressivity rule, non-residents and residents are in a comparable situation, so that application to the former of a higher rate of income tax than that applicable to the latter and to taxpayers who are assimilated to them would constitute indirect discrimination prohibited by Community law"*[1365]. Accordingly, it was up

---

resident taxpayer, the Commission calculates the amount of tax due if the tax-free allowance had been exceeded by 5,039.55 (i.e. the net income from the artistic performance). This calculation demonstrates that the net income from the hypothetical taxpayer's performance would be burdened by an average tax rate of 26.5%. Compared to the actual rate of 25% paid by Gerritse, the Commission found that no discrimination occurred. Remarkably, the Commission applies the *lowest* tax bracket for German residents. Given the circumstances of the case, it might have been more logical to apply the average tax bracket to which a German resident with Gerritse's worldwide income would have been subject in order to construct an appropriate benchmark. However, the conclusion would still be the same (no discrimination): in case a higher tax bracket were applied to the hypothetical taxpayer, the resulting tax rate would still be higher than the 25% applicable to Mr Gerritse.

[1363] C-234/01, *Gerritse*, § 43-45.

[1364] C-234/01, *Gerritse*, § 48.

[1365] C-234/01, *Gerritse*, § 52-53.

to the national court to verify whether the tax rate of 25% was higher than that which would follow from application of the progressive rate. In order to ensure comparability in this regard, it is necessary to add to the net income received in Germany an amount corresponding to the tax-free allowance[1366].

In conclusion, the Court's analysis of the comparability-issue consists of two parts. First, the tax-free allowance serves a social purpose, which means it is legitimate to reserve it to residents. Secondly, the distinction between flat rates for non-residents and progressive rates for residents is indirectly discriminatory if it leads to a higher rate of tax on non-residents. As residents and non-residents are in a comparable situation with regard to the progressivity rule, such a distinction is incompatible with the fundamental freedoms.

So the ECJ's analysis may be summarized as follows:

- There is a relevant difference between non-residents earning a minimal part of their income in the source State and residents of that State.
- Does that difference mean that a flat rate taxation of such non-residents is not discriminatory, considering that residents are taxed at a progressive rate, including a tax-free allowance?
    - As for the tax-free allowance: the social purpose of the measures warrants its restriction to residents.
    - As for the different rates: both categories of taxpayers are comparable, which means that it would be discriminatory to apply a higher rate to non-residents.

The different conclusion on both aspects of the measure can mean one of two things: either residents and non-residents are comparable with respect to one aspect of the measure and incomparable with respect to the other aspect, or residents and non-residents are comparable with respect to both aspects, but their different treatment is justified with respect to one aspect and not with respect to the other aspect. The observation that, since the tax-free allowance serves a 'social purpose', it is 'legitimate' to reserve it to residents, seems to be an indication that the latter interpretation is followed by the ECJ, but this is difficult to reconcile with the earlier observation that residents and non-residents are, as a rule, not comparable. If incomparability is the rule, there is no need to justify different treatment.

However, a close reading of the ECJ's reasoning reveals that the analysis of the tax-free allowance is merely an application of the *Schumacker*-doctrine. The ECJ holds that *"[since] the tax-free allowance […] has a social purpose […] it is legitimate to reserve the grant of that advantage to persons who have received the greater part of their taxable income in the State of taxation, that is to say, as a general rule, residents."* In other words, incomparability is still the rule, which means that it is 'legitimate' to distinguish between residents and non-residents. The advantage is restricted to *"persons who have received the greater part of their taxable income in the State of taxation"*, which means that the *Schumacker*-condition is fulfilled: if a non-resident earns the greater part of his income in the source State, he is entitled to the same tax advantages as a resident.

The reference to the 'social purpose' of the measure, and the 'legitimate' nature of the distinction may cause some confusion, but the ECJ only applies a comparability-test. The wording may point to a justification-analysis (which would presuppose comparability), but no justification is necessary, given the incomparability of the situations. Thus, the ECJ could

[1366] In this respect, see the calculation made by the Commission, referred to in footnote 1362, resulting in a tax rate of 26.5%, which is higher than the rate of 25% that applied to Gerritse.

have restricted itself to referring to the incomparability of the situations and subsequently concluding that no issue of discrimination arose. The reference to the 'social nature' of the measure may serve to emphasize the similarities to *Schumacker*: just like the personal and family circumstances discussed in *Schumacker,* the tax-free allowance is part of the social fabric to be taken into account by the State having jurisdiction over the majority of the taxpayer's income. In most cases, that will be the State of residence. In exceptional cases, however, the taxpayer will earn most of his income elsewhere. That was not the case with Mr Gerritse. Consequently, it was up to his State of residence to grant a tax-free allowance (see also supra, *Gschwind*).

On the other hand, the ECJ expressly states that *"with regard to the progressivity rule, non-residents and residents are in a comparable situation."* As the Court does not refer to the requirement that non-residents and residents are only comparable if the non-resident earns virtually all his income in the source State, it seems that the progressivity rule is an exception to the *Schumacker*-doctrine. More specifically, the progressivity rule is an application of the *Asscher*-reasoning that the general incomparability of residents and non-residents is limited to those elements of the national tax regime which take account of the taxpayer's overall ability to pay. In contrast, residents and non-residents are generally comparable with regard to those elements of the national tax regime which objectively determine the taxable base and the tax liability (e.g. the progressive nature of the tax rate).

The ECJ finds support for its conclusion that residents and non-residents are comparable in this context by noting that the Netherlands, as State of residence, applies the progressivity rule, thereby however taking account of the tax levied in Germany, by deducting from the tax due in the Netherlands a fraction corresponding to the relation between the income taxed in Germany and worldwide income[1367]. Even though the ECJ frames this argument as a matter of comparability, it actually relates do the existence of a disadvantage and should therefore not affect the comparability-issue. The argument is similar to the argument on which the Dutch government relied in *Asscher*, that the higher tax rate counterbalanced the progression benefit enjoyed by non-residents (see 2.E.I.B.c.5). In *Gerritse*, the German government argued that the progressive rate should not be applied to a non-resident such as Mr Gerritse because he would then escape the progressivity of German income tax. Because his income was split between different States, he would be subject to a lower tax rate in Germany than a resident who is taxable there on his worldwide income[1368]. As in *Asscher*, the ECJ responds to that argument by pointing out that Mr Gerritse's home State, the Netherlands, applies the exemption with progression method, with the result that progression is ensured. Apart from being based on an incorrect understanding of how progressivity works (see 2.E.I.B.c.5), the Court's reasoning is flawed where it considers that this progressivity issue means that the situations are comparable[1369]. In view of the rest of its case law, the more correct approach would be to accept that the situations are comparable because of the *Asscher*-exception to *Schumacker* (i.e. that the *Schumacker*-incomparability is only relevant for matters that take accout of the taxpayer's ability to pay tax and not, for instance, for the tax rate) and then to consider whether the subject of comparison suffered a disadvantage[1370]. In the context of that

[1367] C-234/01, *Gerritse,* § 52.
[1368] C-234/01, *Gerritse,* § 14 and 34.
[1369] See C-234/01, *Gerritse*, § 53: *"**That means that**, with regard to the progressivity rule, non-residents and residents are in a comparable situation"* (emphasis added).
[1370] That being said, it could be argued that the optimal solution would be for the taxpayer to report his worldwide income in the source State, so as to enable that State to apply the correct progression in the tax rate applicable to the income sourced there. That would remove the progression benefit and at the same time allow the source State to grant the appropriate personal allowances (see 2.E.I.A.b.1.c).

disadvantage-test, it could then be determined whether the progressivity-advantage outweighs the disadvantage suffered due to the application of the flat rate.

8. Wallentin

Mr Wallentin was a resident national of Germany who was studying in Germany. He received a monthly allowance from his parents and a student grant from the German State. Both sums were tax-free in Germany. In 1996, he undertook a period of work experience in Sweden, for which he was remunerated. Under the Swedish non-residents' income tax regime, a source tax of 25% was due on this remuneration. The Swedish income tax regime on non-residents applied to non-residents receiving income in Sweden during short stays not exceeding six months in a year. The tax was levied at source and there was no right to a deduction or allowance based on the taxpayer's personal situation. The rate of the special income tax was lower than the progressive rate applicable to residents (which would be around 30% in a situation such as that of Mr Wallentin).

Swedish residents received a basic tax-free allowance, but that allowance was granted in full only to those taxpayers resident in Sweden for a full tax year. For periods of residence of less than a year but more than six months, the allowance was granted in proportion to the number of months' residence. Mr Wallentin argued that this distinction between residents and non-residents violated the free movement of workers.

Mr Wallentin argued that he was comparable to a Swedish resident by relying on the second part of the *Schumacker*-doctrine: if a non-resident receives no significant income in his State of residence and obtains the majority of his taxable income from an activity performed in the work State, his State of residence is not in a position to grant him the benefits resulting from the taking into account of his personal and family circumstances. In such a case, it is up to the work State to take account of these circumstances.

The ECJ agreed with Mr Wallentin because he earned no taxable income in his State of residence. Both the monthly allowance paid by his parents and the grant paid by the German State were tax-free. As a result, it was up to the work State, where he earned all his taxable income, to take account of the personal and family circumstances. With regard to the question whether the basic tax-free allowance reflected consideration of the taxpayer's personal and family circumstances, the ECJ referred to its position *Gerritse* (see infra) that such a basic tax-free allowance has a social purpose since it ensures that the taxpayer has a minimum subsistence amount which is not subject to income tax. As a result, the Swedish legislation was held to be discriminatory.

> The Court's refusal to take account of the German allowance and grant could be interpreted in two ways. A first possibility is that the Court only considers **taxable** income, because that is the only type of income in respect of which tax benefits can usefully be granted. Since Mr Wallentin did not earn any taxable income in Germany, it was impossible for that State to grant him any benefits. For that reason, the responsibility shifted to Sweden, where he did have some taxable income. This first interpretation thus starts from the assumption that personal tax benefits have to be granted somewhere in the internal market. Generally, that is the task of the home State, but if that proves impossible (e.g. because of a lack of taxable income there), the responsibility may be shifted to another State.

> There is also a second possible interpretation: it could also be said that, by refusing to take account of the German allowance and grant, the ECJ interprets 'ability to pay' as referring to that part of a taxpayer's income that exceeds what is necessary for his existence. As discussed in Part I, income is generally thought to be the most appropriate indicator for ability to pay tax. But the factor 'income' as such is not precise enough, as it does not take account of personal circumstances such as marital status, having children, etc. In order to take account of those circumstances, States often grant tax exemptions at the base, thus creating a higher tax-free minimum. In the case at hand, the German legislator, by exempting the allowance and grant received by Mr Wallentin, indicates that it considers it necessary for its taxpayers to receive those sums free of tax. The ECJ takes this into account when determining Mr Wallentin's ability to pay in Sweden. More specifically, when ascertaining whether Mr Wallentin is comparable to a Swedish resident (i.e. whether his ability to pay is the same as that of a Swedish resident), the Court disregards the sums that are exempt by Germany and only considers the sums that are not exempt, i.e. the income taxable in Sweden.

9. The D-Case

Mr D was a German resident. 10% of his wealth consisted of real property situated in the Netherlands, while the remainder was held in Germany. In the Netherlands, a wealth tax was imposed, i.e. a direct tax on net assets, charged at a rate of 0.8 % on the amount of those assets. All individuals resident in the Netherlands and all individuals who, although not resident in the Netherlands, had net assets there were subject to the wealth tax. Resident taxpayers were taxed on the basis of their net worldwide assets, non-resident taxpayers were taxed on the basis of the net assets owned by them in the Netherlands. Resident taxpayers were entitled to a tax-free allowance applied to their net worldwide assets, while non-resident taxpayers were not entitled to such an allowance. In 2003, the application of the allowance was extended to non-resident taxpayers at least 90% of whose wealth was held in the Netherlands.

According to Mr D, the different treatment of residents and non-residents fell foul of the free movement of capital[1371]. Before the ECJ, Mr D tried to argue that the case at issue was different from *Schumacker*, contending that wealth tax should be distinguished from income tax. Therefore, solutions adopted in relation to income tax could not necessarily be transposed to wealth tax[1372].

However, the Court disagreed. After reiterating its *Schumacker*-reasoning, the Court held that the situation of a person liable to wealth tax and that of a person liable to income tax are similar in several respects. First of all, wealth tax, like income tax, is a direct tax based on the taxpayer's ability to pay. Wealth tax is often regarded as a complement to income tax, relating to capital in particular. Second, a person liable to wealth tax as a rule holds the greater part of his assets in the State where he is resident, which is usually where his personal and financial interests are centred. Therefore, the Court went on to examine whether, as in the case of income tax, residents and non-resident are, as a rule, incomparable in the context of wealth tax.

[1371] Only the vertical aspect of the *D*-judgment, i.e. the comparison between residents and non-residents, will be addressed here. The horizontal aspect, concerning the comparison between different categories of non-residents, will be discussed in 2.E.I.A.2.9.a.

[1372] C-376/03, *D*, § 20-22.

In this respect, the ECJ first noted that residents of the Netherlands were taxed on the value of all their worldwide wealth, less the allowance. The purpose of this allowance was to ensure that at least a part of the total net assets was exempt from tax. Therefore, it could only perform its function fully if the imposition of the tax related to all the taxpayer's wealth. Consequently, non-residents who were taxed in the Netherlands on only part of their wealth did not in general have grounds for entitlement to the allowance.

Accordingly, the Court observed that as regards wealth tax, as in the case of income tax, the situation of a non-resident is different from that of a resident *"in so far as not only the major part of the latter's income but also the major part of his wealth is normally concentrated in the State where he is resident. Consequently, that Member State is best placed to take account of the resident's overall ability to pay by granting him, where appropriate, the allowances prescribed by its legislation"*[1373]. As a result, a taxpayer who holds only a minor part of his wealth in a Member State other than his State of residence is not, as a rule, comparable to a resident of that other Member State and the refusal to grant him the allowance to which residents are entitled is not discriminatory.

Mr D then advanced a second line of reasoning: the fact that Germany, his State of residence, did not impose a wealth tax meant that he was not entitled in either of the relevant Member States to have his personal and family circumstances taken into account for tax purposes. In other words, because Germany did not levy wealth tax, all of Mr D's relevant wealth was situated in the Netherlands. Consequently, the obligation set out in *Schumacker* would fall on the Netherlands. The Advocate-General took the same approach: *"it is decisive in the present case that no tax of that kind was levied in Germany because, as regards his assets in the Netherlands, D is in the same position as a resident since, in reality, 100% of his taxable wealth is located in the latter country, because the property he owns in his country of domicile is irrelevant for tax purposes"*[1374].

In order to support this argument, the Advocate-General referred to *Wallentin*. As noted above, the Court in *Wallentin* assimilated a taxpayer who only received tax-free income in his State of residence to a taxpayer with no income in his State of residence. As a result, the *Schumacker*-obligation applied to the work State since all of the taxpayer's relevant income was derived in that State. According to the Advocate-General, that line of reasoning should be transposed to the *D*-case: since all of Mr D's taxable assets were in the Netherlands, he was comparable to a resident of the Netherlands. Unlike Mr D, a resident of the Netherlands with 10% of his assets situated in the Netherlands and the rest in Germany would pay no tax in Germany but would nevertheless be entitled to an allowance in the Netherlands. The Advocate-General therefore considered the Dutch regime to be discriminatory.

However, the Court dismissed this line of reasoning. According to the Court, the different treatment at issue could be explained by the fact that the taxpayer held only a minor part of his wealth in the Netherlands and that he was therefore not comparable to residents of that State. The circumstance that Germany, his State of residence, has abolished wealth tax *"has no bearing on this factual situation"*. Since he holds the major part of his wealth in his State of residence, the other State is not required to grant him the benefits which it grants to its own residents.

[1373] C-376/03, *D*, § 31-34.
[1374] Opinion of Advocate-General Colomer in C-376/03, *D*, 26 October 2004, § 64.

Moreover, the Court adds that the case at hand should be distinguished from *Wallentin*, since sums such as the subsistence allowance paid to Mr Wallentin by his parents and the grant which he received from the German State *"did not of their nature constitute taxable income under German tax legislation"*[1375]. As a result, the *Wallentin*-reasoning could not be transposed to the *D*-case. The Court therefore held that the Dutch regime did not violate the free movement of capital[1376].

Commentary

The most troubling aspect of the vertical component of the *D*-case is its relationship to *Wallentin*. Both cases concerned a taxpayer whose taxable income or wealth was situated exclusively in the work State. In *Wallentin*, the Court disregarded the income derived in Germany in applying *Schumacker*, while it refused to do so in respect of the wealth held in Germany in *D*. As pointed out earlier, the Court distinguishes *D* from *Wallentin* by observing that sums such as the subsistence allowance paid to Mr Wallentin by his parents and the grant which he received from the German State *"did not of their nature constitute taxable income under German tax legislation"*. Apparently, the Court considers the opposite to be true for the wealth held in Germany by Mr D, with the result that the *Wallentin*-solution could not be applied to the case at hand.

However, that distinction is not very convincing. Why should there be a difference between the situation where Germany decides not to tax wealth and the situation where it decides not to tax a subsistence allowance? Perhaps a parellel could be drawn to *Schempp*, where the ECJ held that the non-taxation of maintenance payments in Germany on the ground that the recipient's income did not exceed the tax-free threshold could not be compared to the non-taxation of maintenance payments in Austria on the ground of its non-taxable character in that State. According to the Court, the fiscal consequences which attach to each of those situations as regards the taxation of income are different for the taxpayers concerned[1377]. In other words, the situation where income is not taxable because the tax-free threshold is not met cannot be compared with the situation where a certain type of income is exempt in the Member State in question. This is quite similar to denying the comparability of the situation where a subsistence allowance and a government grant are not taxable because those sums did not 'of their nature' constitute taxable income under domestic tax law and the situation where wealth is not taxable in a Member State because that State has decided not to implement a wealth tax[1378].

Apart from the distinction made by the Court, I see two differences between *Wallentin* and *D* that might explain the different approach taken by the Court. First, the taxpayer in *Wallentin* earned different types of income in the work State and in the residence State (employment income in Sweden, a subsistence allowance and a government grant in Germany). In contrast, the taxpayer in *D* held the same type of wealth in both States but only one State subjected that wealth to tax. Secondly, the Court in *D* expressly notes that the allowance at issue was *"intended to ensure that at least a part of the total net assets of the taxable person concerned*

[1375] C-376/03, *D*, § 42. See also C-169/03, *Wallentin*, § 3: *"Those sums did not* ***of their nature*** *constitute taxable income under German tax law"* (emphasis added) and the operative part of the judgment: *"when the persons not resident in the State of taxation have had, in their own State of residence, only income which,* ***by its nature****, is not subject to income tax"* (emphasis added).
[1376] C-376/03, *D*, § 39-43.
[1377] C-403/03, *Schempp*, § 39.
[1378] See, however, 2.E.II.C.c: the analogy with *Schempp* does not hold.

is exempt from wealth tax", with the result that it *"performs its function fully only if the imposition of the tax relates to all his wealth"*[1379]. The latter point in particular seems to have been important in the Court's approach. According to the Court, the allowance can function fully only if (almost) all of the taxpayer's wealth is subject to tax in the Netherlands[1380]. Taxpayers such as Mr D, the majority of whose wealth is situated outside the Netherlands, are therefore not comparable to residents with respect to such an allowance[1381].

That being said, the core issue in trying to reconcile *Wallentin* and *D* is arguably that *Wallentin* was based on the incorrect premiss that there are certain items of income which are 'by their nature' not subject to tax. There is nothing to prevent a Member State from making subsistence allowances or government grants subject to income tax (and making them deductible for the payer) in the same way as, for instance, wages. The taxability of such types of income is not a matter of their 'nature', but merely of national tax policy[1382]. Similarly, it is a matter of national tax policy for a Member State to decide whether or not wealth should be taxable[1383]. As a more general point, it could be argued that the artificial distinction used by the Court in *D* reveals a fundamental weakness in the *Schumacker*-doctrine. Basically, the Court's criterion in *Schumacker* of a non-resident who *"receives the major part of his income and almost all his family income in a Member State other than that of his residence"*

[1379] C-376/03, *D*, § 36. Another point that could possibly be made is that it was clear in *Wallentin* that the grant of the allowance at issue *"would not give Mr Wallentin an unjustified fiscal benefit since he has no taxable income in his Member State of residence which could confer entitlement to a similar allowance in that State"* (C-169/03, *Wallentin*, §23). That was not the situation in *D*: the fact that Germany did not tax Mr D's wealth did not affect his ability to pay tax in Germany. Germany was still in a position to take Mr D's personal circumstances into account (see T. O'SHEA, "The ECJ, the D case, double tax conventions and most-favoured nations: comparability and reciprocity", *EC Tax Review* 2005, 193). However, it is difficult to assess whether this consideration affected the Court's conclusion, since there is no information in the judgment on the composition of the taxpayer's income.

[1380] Obviously, that observation is irrelevant with respect to non-residents who are entitled to the benefit under a tax treaty concluded by the Netherlands (for instance the treaty with Belgium: see 2.E.I.A.b.9.a, on the horizontal aspect of *D*).

[1381] Possibly, an additional difference between *D* and *Wallentin* is that *D* can be seen as a disparity-case while *Wallentin* concerned a discrimination-issue. In particular, it could be argued that the disadvantages in *D* were caused by the fact that Germany did not levy a wealth tax while the Netherlands did (see also G. KOFLER and C. SCHINDLER, "Dancing with Mr D: the ECJ's denial of most-favoured-nation treatment in the D case", *European Taxation* 2005, 536). That difference in the tax regimes of the Member States involved could be seen as a disparity; so the fact that Germany, unlike the Netherlands, chose not to introduce a wealth tax cannot be considered to constitute discrimination on the part of the Netherlands (see 2.E.II). Unfortunately, the Court does not address this possibility.

[1382] B. TERRA and P. WATTEL, *European Tax Law. Fifth Edition*, Kluwer Law International, Alphen aan den Rijn, 2008, 796.

[1383] Nevertheless, the ECJ applied the *Wallentin*-approach again in C-329/05, *Meindl*, 25 January 2007. In that case, a German resident received income in Germany from professional activities totalling DEM 138,000. The only income of his spouse, an Austria resident, was a maternity allowance and a family allowance in Austria totalling DEM 27,000. None of these sums were considered to constitute taxable income in Austria. The taxpayers applied for joint assessment in Germany. Under German domestic tax law, a joint assessment was only possible where at least 90% of the income of both spouses was subject to German tax or where the amount of income not subject to that tax did not exceed DEM 24,000. The ECJ held that the taxpayers should be entitled to joint assessment in Germany because Mr Meindl *"received the entire taxable income of the household"* in Germany, his State of residence. According to the Court, *"a resident taxpayer whose spouse is resident in the same Member State and receives there only income not subject to tax is objectively in the same situation as a resident taxpayer whose spouse is resident in another Member State and receives there only income not subject to tax because, in both cases, the household's taxable income is derived from the professional activity of only one of the spouses and, in both cases, that spouse is the resident taxpayer."* Since a German resident taxpayer whose spouse was also a German resident and who received only income not subject to tax in Germany was entitled to the allowance, there was discrimination.

presupposes the existence of a European-wide definition of income. However, such a definition does not exist. From that perspective, the Court's attempt to distinguish *D* from *Wallentin* by introducting a concept of 'taxable income by nature' has been criticized as being inconsistent[1384].

10. Turpeinen

Ms Turpeinen was a retired Finnish national who resided in Spain. Until 1998, Ms Turpeinen was domiciled in Finland and worked in the Finnish public service. In 1998 she took early retirement and moved to Belgium. In 1999, when she took her final retirement, she settled permanently in Spain. Ms Turpeinen's only income was a Finnish retirement pension. By virtue of the tax treaty between Finland and Spain, the retirement pension, paid on the basis of employment in the public sector, was taxable only in Finland. Until 2001, Ms Turpeinen was subject in Finland to the tax regime for residents, which covered her worldwide income. The Finnish regime provided for progressive taxation, according to which a tax rate of 28.5% was applicable to Ms Turpeinen's retirement pension.

In 2002, the Finnish tax administration informed Ms Turpeinen that thenceforth she was to be subject to the limited taxation regime, which covered only income from Finland and applied to Finnish nationals who had not been domiciled in Finland for three years consecutively. Under that regime Ms Turpeinen's retirement pension was subject to a withholding tax of 35%. Ms Turpeinen argued that the refusal to treat her as a resident, i.e. to apply the progressive rate, violated the free movement provisions.

After observing that the free movement of workers could not be applied because Ms Turpeinen had exercised the right to reside in another Member State only after her retirement, without any intention of working in that State[1385], the ECJ examined whether Art. 21 TFEU (former Art. 18 EC) could be applied. In this regard, the Court first noted that the status of citizen of the Union is the fundamental status of nationals of the Member States, enabling such nationals who find themselves in the same situation to enjoy within the scope ratione materiae of the Treaty the same treatment in law irrespective of their nationality. Situations falling within the scope of EU law include those involving the exercise of the fundamental freedoms guaranteed by the Treaty, in particular those involving the freedom to move and reside within the territory of the Member States, as conferred by Art. 21 TFEU. Accordingly, it would be contrary to this equal treatment-requirement were a citizen to receive in the Member State of which he is a national treatment less favourable than he would enjoy if he had not availed himself of the freedom of movement provisions. Those provisions could not be fully effective if a national of a Member State could be deterred from availing himself of them by obstacles placed in the way of his stay in the host Member State by legislation in his State of origin penalising the fact that he has used them. Therefore, national legislation which places some of its nationals at a disadvantage simply because they have exercised their freedom to move and to reside in another Member State would give rise to inequality of treatment, contrary to the principles which underpin the status of citizen of the Union, that is, the guarantee of the same treatment in law in the exercise of the citizen's freedom to move[1386].

[1384] M. LANG, "Recent case law of the ECJ in direct taxation: trends, tensions and contradictions", *EC Tax Review* 2009, 102.
[1385] *Turpeinen*, § 13-16.
[1386] *Turpeinen*, § 18-22.

As Ms Turpeinen had exercised her rights to freedom of movement and residence conferred by Article 21 TFEU, she could thus rely on that provision against her State of origin. The Finnish tax legislation at issue introduced a difference in treatment between Finnish nationals who continued to reside in Finland and those who established their residence in another Member State, resulting simply from the latter having exercised their right to freedom of movement.

The Court then reiterates the *Schumacker*-doctrine and holds that it *"applies mutatis mutandis in a situation such as that in the main proceedings, where a retirement pension constitutes the taxable income."* Finnish tax legislation provided that retirement pensions such as that paid to Ms Turpeinen were, in the case of resident taxpayers, taxed in the same way as any income deriving directly from an economic activity, on a progressive scale and with allowances to take into account the taxpayer's ability to pay tax and his personal and family circumstances. Consequently, the Court holds that, in so far as the retirement pension paid in Finland constitutes all or almost all of their income, non-resident retired persons such as Ms Turpeinen are, objectively speaking, in the same situation as regards income tax as retired persons resident in Finland who receive the same retirement pension. As the Finnish government did not succeed in justifying the discrimination, the measure was found to violate Article 21 TFEU[1387].

Turpeinen is quite an extensive application of the *Schumacker*-doctrine. Traditionally, the *Schumacker*-doctrine required that the applicable rules had to be aimed at taking into account personal and family circumstances. However, the only reference to personal and family circumstances in *Turpeinen* was the observation that under Finnish tax legislation retirement pensions such as that paid to Ms Turpeinen were, in the case of resident taxpayers, *"taxed in the same way as any income deriving directly from an economic activity, on a progressive scale* ***and with allowances to take into account the taxpayer's ability to pay tax and his personal and family circumstances****"*[1388]. If the *Schumacker*-doctrine is to be applied in all cases where income is taxed on a progressive scale and with allowances to take account of the taxpayer's ability to pay and his personal and family circumstances, then nearly all income tax cases come within the scope of this doctrine[1389]. It is questionable whether that broad interpretation finds any support in the ratio underlying the *Schumacker*-doctrine (i.e. that comparability with respect to taxpayers' ability to pay is determined by the place where their income is concentrated; see supra).

b. Extension of the Schumacker-doctrine to negative income from immovable property

1. Ritter-Coulais[1390]

The ECJ's approach

Mr and Mrs Ritter-Coulais, both German nationals[1391], were jointly assessed in Germany to income tax on their total income. They owned and occupied a house in France but both worked as teachers in a state secondary school in Germany. German domestic tax law provided that all persons, irrespective of nationality, having their permanent residence in

[1387] *Turpeinen*, § 26-39.
[1388] *Turpeinen*, § 30; emphasis added.
[1389] M. LANG, "Recent case law of the ECJ in direct taxation: trends, tensions and contradictions", *EC Tax Review* 2009, 102.
[1390] C-152/03, *Hans-Jürgen Ritter-Coulais, Monique Ritter-Coulais v Finanzamt Germersheim*, 21 February 2006, *ECR* 2006 I-1711.
[1391] Mrs Ritter-Coulais had dual French-German nationality.

Germany were subject to German tax, as were German nationals not having their permanent residence in Germany but working in the public service in Germany. Pursuant to Article 14 of the tax treaty between France and Germany[1392], the income earned in respect of their employment as teachers in the German state school was taxable exclusively in Germany. Article 3 of the tax treaty provided that income from immovable property was only taxable in the State where the property was situated.

Under German law at the time, the term ‘income’ covered both positive income, i.e. a gain for the taxpayer concerned, and negative income, i.e. a loss or *lucrum cessans* for that taxpayer. Such negative income could arise, for instance, as a result of individuals using their immovable property for their personal use. Under Article 20(I)(a) of the tax treaty, income that was taxable in France under the treaty was excluded from the taxable base in Germany. However, that did not restrict the right of Germany to take this income into account in determining its tax rate. German tax law thus provided that foreign income that was exempt under a tax treaty was included in the taxpayer’s taxable income for the sole purpose of determining the applicable rate of tax.

In the case of negative income, this progressivity mechanism resulted in a lower tax rate. However, that rule did not apply in the case of negative foreign income from immovable property situated abroad: in the absence of positive income from immovable property in another state, no account was taken of negative income of that kind incurred in the same state for the purposes of determining the tax rate. So the combined effect of the provisions in question was that negative income from immovable property situated abroad could not be taken into account for the purpose of determining the tax rate in Germany, whereas negative income from immovable property in Germany could be taken into account for those purposes.

The Court first observed that under the German legislation at issue, positive income deriving from the use of a dwelling situated abroad was taken into account for the purposes of determining the tax rate, but in the absence of such positive income, no account was taken of income losses of that type. According to the ECJ, this implied that individuals such as the Ritter-Coulais, who worked in Germany whilst residing in their own home in another Member State, *“were not entitled, in the absence of positive income, to have income losses relating to the use of their home taken into account for the purposes of determining their income tax rate, in contrast with individuals working and residing in their own homes in Germany. Even though the national legislation was not specifically directed at non-residents, the latter are more likely to own a home outside Germany than resident citizens”*[1393]. Consequently, the treatment of non-resident workers was less favourable than that afforded to workers who resided in Germany in their own homes. The ECJ thus concluded that the German measure fell foul of the free movement of workers.

The Court’s reasoning is remarkable. Particularly the complete absence of any reference to the comparability-test raises some questions. The comparison to be made was between individuals such as the Ritter-Coulais (i.e. non-residents earning all of their income in

[1392] *“Salaries, wages and similar remuneration and retirement pensions paid by one of the Contracting States […] to individuals who are residents of the other State in respect of present or past administrative or military services, shall be taxable only in the first-mentioned State. This provision shall not, however, apply where the remuneration is paid to a person who possesses the nationality of the other State without being at the same time a national of the first-mentioned State; in this case, the remuneration shall be taxable only in the State of which the person concerned is a resident.”*

[1393] C-152/03, *Ritter-Coulais*, § 34-36.

Germany) and a German resident earning all of his income in Germany. Given the general rule in *Schumacker* that residents and non-residents are, as a rule, not comparable, it seems odd that the ECJ apparently decided a priori that the comparability test was passed in *Ritter-Coulais.*

The specific circumstances of the case may offer an explanation for this position. In particular, domestic tax law provided that German nationals not having their permanent residence in Germany but working in the public service in Germany were taxed on their worldwide income. Therefore, non-residents in the situation of the Ritter-Coulais were treated in Germany as if they were German residents. This equation with residents might explain why the ECJ skips the first step of its analysis, and, after having decided that the free movement of workers applies, immediately takes the second step, i.e. the question whether the subject of comparison was treated less favourably. Accordingly, the comparison made by the Court is not between residents and non-residents, but between two categories of residents: residents with foreign lossses on the one hand, and residents with domestic losses on the other hand[1394]. In the Court's reasoning, it was therefore not necessary to resort to the *Schumacker*-doctrine, which concerns the comparability of residents and non-residents.

The Advocate-General's approach

It may be interesting to compare the ECJ's reasoning to the Advocate-General's opinion in *Ritter-Coulais*. Unlike the ECJ, the Advocate-General explicitly addresses the comparability issue. The Advocate-General first repeats the traditional *Schumacker*-doctrine[1395] and then applies it to the case at hand, stating that *"non-residents such as Mr and Mrs Ritter-Coulais, all or almost all of whose worldwide income arises in Germany, must be considered, in terms of the rules governing the computation of their income tax, as being in a comparable situation to that of persons who reside and work in that Member State."* So unlike the Court, the Advocate-General considers the Ritter-Coulais to be **French** residents. This explains why the Advocate-General addresses the comparability issue in detail. He then states: *"The difference in treatment between taxpayers who work in a Member State but are not resident there and taxpayers who both work and reside in the State in question, which consists in the former being denied recognition of negative letting income, does therefore constitute, to that extent, indirect discrimination based on the criterion of residence"*[1396].

This is a considerable extension of the *Schumacker*-doctrine. Whereas *Schumacker* only concerned comparability with regard to tax benefits based on personal and family circumstances, the Advocate-General in *Ritter-Coulais* indicates that the same reasoning should apply *"in terms of the rules governing the computation of their income tax."* According to the Advocate-General, *"the import of the [Schumacker-case law] is that the taxation of taxable persons in their State of employment or in their State of residence must not*

[1394] See C-152/03, *Ritter-Coulais*, § 18, where the Court states that the relevant question is whether the fundamental freedoms *"preclude national legislation, such as that at issue in the main proceedings, which does not permit natural persons in receipt of income from employment in one Member State and* ***assessable to tax on their total income there****, to request that account be taken, for the purposes of determining the rate of taxation applicable to that income in that state, of rental income losses relating to their own use of a private dwelling in another Member State"* (emphasis added). See also M. LANG, "Recent case law of the ECJ in direct taxation: trends, tensions and contradictions", *EC Tax Review* 2009, 103. Given the tie-breaker rule in the applicable French-German tax treaty, the Ritter-Coulais would most likely have been French residents. However, the Court did not take note of this.
[1395] Opinion of Advocate-General Léger in C-152/03, *Ritter-Coulais*, § 82-84.
[1396] Opinion of Advocate-General Léger in C-152/03, *Ritter-Coulais*, § 91-92.

ultimately lead to a situation in which their personal and family circumstances are not taken into account in either, or are taken into account only in part."

In the following two paragraphs, the Advocate-General extrapolates this argument to a broader interpretation[1397]: "*More generally, this case-law means, in my view, that* ***non-residents' ability to pay tax****, which depends not only on account being taken of their personal and family circumstances*[1398]*, but also on* ***account being taken of their total income and losses***[1399]*, should not be assessed differently by the competent authorities on the sole ground of place of residence, where resident and non-resident taxpayers alike receive all or virtually all their taxable income in the taxing State. But that is indeed the situation that results from national legislation which, in the case of non-residents,* ***takes no account of negative foreign income****, in the form of rental income* ***losses****, for the purposes of determining taxable income and/or the rate of tax, whereas account is taken of such losses in the case of residents who also receive all or almost all their income in that Member State"*.

In the subsequent *Lakebrink*-case, the Court adopted the approach proposed by the Advocate-General (see hereafter).

2. Lakebrink[1400]

The ECJ's approach

In *Lakebrink*, the ECJ was asked to decide a case with some striking similarities to *Ritter-Coulais*. Yet, there were also important differences between both cases. First, the losses claimed by the applicants in *Lakebrink* related to properties which had been let and which they did not occupy themselves. A more important difference, however, is the comparison made by the Court in *Lakebrink*: unlike *Ritter-Coulais,* the comparison was not between two types of residents[1401], but between residents and non-residents.

Mr and Mrs Lakebrink, German nationals resident in Germany, were both employed exclusively in Luxembourg. For the year 2002, they applied in Luxembourg for joint tax assessment as provided for by Luxembourg tax law. In their tax return to the Luxembourg tax

---

[1397] Opinion of Advocate-General Léger in C-152/03, *Ritter-Coulais*, § 98-99 (emphasis in original text).

[1398] The Advocate-General refers to the following examples of tax benefits arising from account being taken of a taxpayer's personal and family situation: the mitigation of the progressive nature of income tax rates for married couples (see *Schumacker*), the deductibility of profits invested in the formation of a pension reserve (see *Wielockx*) and tax allowances related to personal liabilities such as maintenance payments (see *De Groot*).

[1399] With respect to the necessity to take account of a taxpayer's total income and losses, the Advocate-General refers to the part of the ECJ's judgment in *Gerritse* concerning the deductibility of business expenses as an example: *"the Court held there that the Treaty rules on freedom to provide services preclude a national provision which, as a general rule, taxes non-residents on their gross income, without deduction of business expenses, whereas residents are taxed on their net income, after deduction of such expenses."* The Advocate-General concludes by admitting that his proposed approach *"has the effect of placing resident and non-resident taxpayers on a fully equal footing with regard to a range of tax benefits which are often inextricably bound up with economic or social policy choices that are the purview of Member States."* As an example of such a tax benefit, the Advocate-General refers to the (then pending) *Conijn*-case, concerning the deductibility of costs incurred in obtaining tax advice for the purpose of preparing a tax return (which was ultimately decided in line with *Gerritse*, see infra). Yet, as will become apparent in 2.E.I.A.b.2, *Gerritse* and *Conijn* were not applications of the *Schumacker*-doctrine. Rather, these cases are illustrations of the idea that residents and non-residents are, in general, comparable as regards income-related benefits.

[1400] C-182/06, *Luxembourg v Hans Ulrich Lakebrink, Katrin Peters-Lakebrink*, 18 July 2007, *ECR* 2007, I-6705.

[1401] That is to say, in *Ritter-Coulais*, the comparison was between residents and non-residents who were treated as if they were residents. For the purpose of the Court's analysis, that was the same as a comparison between two residents (see supra).

authorities, Mr and Mrs Lakebrink declared negative rental income in connection with two properties in Germany which they owned but did not occupy themselves. They applied for this rental loss to be taken into account for the purposes of determining the tax rate applicable to residents. Under the tax treaty between Germany and Luxembourg, income from immovable property was taxable exclusively in the State where the property was situated. In their German income tax notice for the year 2002, the negative rental income was duly noted, but Mr and Mrs Lakebrink did not receive taxable income in Germany, with the result that they did not pay any tax there.

As requested, Mr and Mrs Lakebrink were taxed jointly in Luxembourg. Under Luxembourg tax law, tax was calculated at the rate which would have applied if they had been Luxembourg residents. The negative rental income from their properties in Germany was not, however, taken into consideration for the purposes of determining the rate: under the tax regime applicable to non-resident taxpayers, the progressivity clause applied only to the foreign **earned** income of non-resident taxpayers, and therefore not to other categories of income such as income from the letting of immovable property. By contrast, under the tax regime applicable to resident taxpayers, the progressivity rule applied when calculating the tax rate on their worldwide income. Unlike residents, therefore, non-residents were unable to enjoy the progressivity benefits of negative income from immovable property situated abroad. The ECJ was asked whether this distinction gave rise to discrimination.

The Court first examined whether non-residents were treated less favourably under the Luxembourg regime[1402] (see 2.E.I.B.c.7). As to the comparability-issue, the ECJ first repeats its *Schumacker*-doctrine[1403] and then holds that *"that case-law applies to a situation such as that in the main proceedings"*. The Court finds two arguments to support this conclusion. First, the *Schumacker*-style discrimination a fortiori concerns non-residents who receive no income at all in their State of residence and obtain all their family income from an activity performed in the State of employment. Secondly, *"the ground […] on the basis of which the Court made its finding of discrimination in Schumacker concerns […] **all the tax advantages connected with the non-resident's ability to pay tax** which are not taken into account either in the State of residence or in the State of employment […], since the ability to pay tax may indeed be regarded as forming part of the personal situation of the non-resident within the meaning of the judgment in Schumacker"*[1404]. The Court therefore decides that the Luxembourg measure infringes the free movement of workers.

The ECJ thus extends the scope of application of the *Schumacker*-doctrine significantly, by including (tax advantages connected with) the non-resident's ability to pay tax. In this respect, it should be pointed out that the Court's statement that *"the ability to pay tax may indeed be regarded as forming part of the personal situation of the non-resident within the meaning of the judgment in Schumacker"* is questionable. Instead, the opposite is true: a taxpayer's personal situation (marital status, etc.) **forms part of** his ability to pay tax, which is also determined by other elements. An example of such a relevant element apart from the taxpayer's personal situation is the negative income from property situated abroad. The Court even expressly pointed this out in *Schumacker*: *"a non-resident's personal ability to pay tax,*

[1402] C-182/06, *Lakebrink*, § 18-24.
[1403] C-182/06, *Lakebrink*, § 28-31.
[1404] C-182/06, *Lakebrink*, § 34 (emphasis added), referring to the Advocate-General's opinion in *Ritter-Coulais*, § 97-99.

determined by reference to his aggregate income and his personal and family circumstances […]"[1405].

The Advocate-General's approach

In his opinion in *Lakebrink*, the Advocate-General had arrived at the same conclusion as the Court. He first indicated that the ECJ's *Schumacker*-style decisions specifically concerned personal and family circumstances, but he indicated that that did not mean that the Court intended to confine the *Schumacker*-argument to those aspect of the taxpayer's overall ability to pay[1406]. Consequently, in order to assess whether residents and non-residents may be comparable in the light of *"a tax benefit unconnected with the non-resident taxpayer's personal and family circumstances"*, the Advocate-General considered it necessary to verify whether the **reason** on which the ECJ based its *Schumacker*-decision, also held good in relation to the tax benefit at issue.

According to the Advocate-General, the reason on which the distinction in *Schumacker* was based, was the fact that a non-resident taxpayer generally *"receives only part of his income in the State of employment and could, therefore, in theory enjoy the tax benefits pertaining to his personal taxation position twice over, that is to say both in the State of residence and in the State of employment."* However, if the non-resident receives (virtually) all of his taxable income in the State of employment, there is no longer a risk that he will enjoy those benefits twice: the State of residence will not be able to take account of his personal tax position because he does not receive significant income there. Consequently, there ceases to be any difference as compared with the situation of a resident taxpayer. *"The corollary of this is that proper application of the principle of non-discrimination […] requires the State of employment to treat a non-resident (virtually) all of whose income is generated in its territory in the same way as a resident, not only as regards the grant of tax benefits linked to the non-resident's personal and family circumstances, but also in relation to any aspect of his overall ability to pay which is relevant for according tax benefits to residents"*[1407].

3. Renneberg[1408]

The ECJ's approach

Mr Renneberg was a national of the Netherlands who resided in Belgium in a dwelling of his own which had been financed with a mortgage loan from a Dutch bank. Mr Renneberg was employed as a public servant by a municipality in the Netherlands. In the taxable years at issue, he received his entire employment income in the Netherlands. In Belgium, Mr Renneberg was liable to a property tax ('précompte immobilier') on his dwelling, but the negative income from his Belgian dwelling[1409] did not affect the amount of that tax. Mr Renneberg therefore deducted this negative income from his employment income that was taxable in the Netherlands.

[1405] C-279/93, *Schumacker*, § 32. See also Opinion of Advocate-General Mengozzi in C-527/06, *Renneberg*, 25 June 2008, 54-57.
[1406] Opinion of Advocate-General Mengozzi in C-182/06, *Lakebrink*, § 33.
[1407] Opinion of Advocate-General Mengozzi in C-182/06, *Lakebrink*, § 34-36.
[1408] C-527/06, *Renneberg*, 16 October 2008.
[1409] The Court refers to 'rental losses', but Mr Renneberg had no actual rental income. Instead, he had a personal dwelling in Belgium, in respect of which he had to include a small fictitious amount of income in his taxable base. This 'positive income' (deemed to be the rental value of the dwelling) was subsequently reduced by the mortgage interest paid, which resulted in the 'negative income' from immovable property.

Pursuant to Art. 4 of the Belgian/Dutch tax treaty, Renneberg was a resident of Belgium for tax treaty purposes. Art. 19 of the tax treaty (on government services) assigned the power to tax Renneberg's employment income to the Netherlands. Art. 6 of the tax treaty provided that income from immovable property was taxable in the State where the property was located (i.e. Belgium in the case of Renneberg's dwelling).

Under the domestic tax legislation at the time in the Netherlands, public servants such as Mr Renneberg were deemed to be residents of the Netherlands. As a result, he was taxable on his worldwide income in the Netherlands, including his employment income and the negative income from his personal dwelling (irrespective of the fact that the dwelling was located in Belgium). The domestic tax laws in the Netherlands further provided that residents of the Netherlands could deduct negative income from real estate from other items of income. However, it was settled case law of the Dutch Supreme Court that the deemed residence of public servants in the Netherlands had to be disregarded in a situation such as that of Mr Renneberg because the tax treaty overrules the domestic deemed residence rule[1410]. As a result, Renneberg was regarded as a non-resident in the Netherlands whose employment income was taxable in the Netherlands, while Belgium had the authority to tax the income from his dwelling.

Because Mr Renneberg was considered to be a non-resident, the Dutch tax authorities refused the deduction of the negative income from his Belgian dwelling. Renneberg argued that this refusal violated the free movement of workers. The case was ultimately brought before the Supreme Court which referred the matter to the ECJ[1411]. Thus, the ECJ was faced with the question whether *Renneberg* should be decided as a matter of personal allowances, in line with *Lakebrink* and the Advocate-General's opinion in *Ritter-Coulais* (see supra) or as a matter of allocation of taxing powers, in line with *Gilly* (see infra). Ultimately, the ECJ chose the former course, applying *Lakebrink*.

The ECJ first compared Mr Renneberg (who was unable to deduct the negative income from his real estate in Belgium in the calculation of his taxable base in the Netherlands) to a resident of the Netherlands (who could deduct such negative income)[1412]. In line with the

[1410] C-527/06, *Renneberg*, § 18. For a critical analysis of the Supreme Court's argument: F. POTGENS and W. GEURSEN, "Renneberg: is mortgage interest paid on an owner-occupied dwelling in Belgium deductible from Netherlands-source employment income?", *European Taxation* 2007, 500-502.

[1411] Interestingly, the Dutch Supreme Court had decided earlier in a similar case that *Schumacker* was only relevant for tax advantages based on a taxpayer's personal and family situation, not for tax advantages relating to negative income from a principal dwelling in Belgium (Dutch Supreme Court, 20 December 2000, *BNB* 2001/192). The fact that the Supreme Court decided to request a preliminary ruling in the *Renneberg*-case can perhaps be explained by a similar question arising in *Ritter-Coulais*, which was referred to the ECJ during the Supreme Court's proceedings in *Renneberg*. However, the ECJ ultimately left this question unanswered in *Ritter-Coulais* (see supra), which prompted the Supreme Court to refer the *Renneberg*-case to the ECJ for a preliminary ruling. See also F. POTGENS and W. GEURSEN, "Renneberg: is mortgage interest paid on an owner-occupied dwelling in Belgium deductible from Netherlands-source employment income?", *European Taxation* 2007, 500.

[1412] C-527/06, *Renneberg*, § 45-46. The question arises whether the proper comparison is with a resident of the Netherlands with negative income from his own dwelling in the Netherlands or with a resident of the Netherlands with negative income from immovable property located in Belgium (e.g. a second dwelling). This distinction would be important if the deductibility in the Netherlands of negative income from immovable property only applied to the dwelling occupied by the taxpayer. In that case, a resident of the Netherlands with a second dwelling in Belgium would not be entitled to the deduction either. So the comparison would have to be with a resident of the Netherlands with negative losses from his own dwelling which, by definition, is located in the Netherlands. But this distinction was of minor importance in *Renneberg* since residents could deduct both income from immovable property located in the Netherlands and from immovable property located elsewhere position taken by the Dutch Supreme Court (see supra), the ECJ thus considered Mr Renneberg to be a non-resident in the Netherlands[1413].

The ECJ then examined whether the disadvantage incurred by Mr Renneberg was merely due to the allocation of taxing powers laid down by the tax treaty. In this regard, the ECJ first referred to its traditional position that, in the absence of harmonising EU measures, the Member States retain competence for allocating the power of taxation with a view to eliminating double taxation by means, inter alia, of international agreements. In that context, the Member States are free to determine the connecting factors for the allocation of fiscal jurisdiction in tax treaties. However, as far as the **exercise** of the power of taxation so allocated is concerned, the Member States must comply with the prohibition of discrimination provided for by EU law. Applied to the context of *Renneberg*, the ECJ observes that the use made by the tax treaty partners of their liberty to allocate fiscal jurisdiction does not mean that the Netherlands has no power whatsoever to take account of negative income from immovable property in Belgium, for the purposes of determining the taxable base of a non-resident who obtains (almost) all of his taxable income in the Netherlands. In particular, income from immovable property in Belgium received by a **resident** was included in that resident's taxable base in the Netherlands, even though Belgium exercised its fiscal jurisdiction in respect of that income[1414].

More precisely, positive income from immovable property situated in Belgium was included in the taxable base in the Netherlands under Article 24 of the tax treaty, but a reduction in the tax proportional to the amount of that income in the basis of assessment was granted in order to avoid double taxation[1415]. On the other hand, negative income from immovable property in Belgium could be taken into account in the determination of the taxable income of resident taxpayers in the Netherlands and, provided that positive income was received from that property in a subsequent year, the relief for double taxation on that positive income was decreased accordingly.

The ECJ therefore holds that, since the tax treaty does not preclude the Netherlands from taking account of negative income from immovable property in Belgium received by a

---

(the latter subject to a claw-back mechanism; see hereafter). For that reason, the Court seems to compare Mr Renneberg both to a resident with negative income from his own dwelling and to a resident with negative income from immovable property located in Belgium (see § 65 of the decision: *"A taxpayer such as Mr Renneberg cannot, for the purposes of determining the basis of assessment of the tax on his work-related income received in the Netherlands, request that rental losses relating to immovable property which he owns in Belgium be taken into account, unlike a taxpayer who resides and works in the Netherlands and who, suffering rental losses relating* ***either*** *to immovable property in the Netherlands which he occupies himself* ***or*** *to immovable property in Belgium which he does not himself occupy on a permanent basis, may set off those losses for the purposes of determining the basis of assessment of income tax in the Netherlands"* (emphasis added)).

[1413] This can be contrasted with *Ritter-Coulais*, in which the Court considered the taxpayer to be a resident, meaning that the *Schumacker*-doctrine was not applicable (supra).

[1414] C-527/06, *Renneberg*, § 52-53.

[1415] Art. 24(1) of the tax treaty read as follows: *"With regard to residents of the Netherlands, double taxation is avoided in the following manner:*

1. The Netherlands may, when taxing its residents, include in the basis of assessment the items of income or capital which, in accordance with the provisions of this Convention, are taxable in Belgium;

2. Subject to the application of the provisions relating to compensation for losses laid down in the domestic rules for the avoidance of double taxation, the Netherlands will make a reduction in the amount of tax calculated in accordance with [subparagraph] (1). The reduction is to be equal to the amount of tax corresponding to the ratio between the amount of income or capital included in the basis of assessment referred to in [subparagraph] (1) and taxable in Belgium under [in particular, Article] 6 of this Convention, and the amount of the total income or total capital constituting the basis of assessment referred to in [subparagraph] (1)."

resident when calculating his taxable income, it was evident that the refusal by the Dutch tax authorities was *"not the result of the choice made in the Convention to allocate the power to tax income from immovable property of taxpayers falling within the scope of the Convention to the Member State in whose territory that property is located. […] The taking into account of the relevant negative income, or the refusal to do so, thus depends in reality on whether or not those taxpayers are residents of the Netherlands"*[1416].

The ECJ thus declares the *Gilly*-reasoning (see infra) inapplicable in the context of *Renneberg*. The ECJ therefore examines the case under its traditional discrimination-analysis, applying the *Schumacker*-doctrine. The ECJ also refers to *Lakebrink*, where it was held that the scope of the *Schumacker*-reasoning *"extends to all the tax advantages connected with the non-resident's ability to pay tax which are granted neither in the State of residence nor in the State of employment"* (see supra). For that reason, the ECJ indicates that *Schumacker* applies to Mr Renneberg's situation as well. More precisely, a taxpayer such as Mr Renneberg cannot request that rental losses relating to immovable property situated in Belgium be taken into account for the purposes of determining the taxable base as regards his employment income received in the Netherlands. In contrast, a taxpayer who resides and works in the Netherlands and who, suffering rental losses relating to immovable property situated in Belgium, may set off those losses for the purposes of determining the taxable base in the Netherlands.

The ECJ thus observes that, *"to the extent that, although residing in one Member State, a person such as Mr Renneberg derives most of his taxable income from salaried employment in another Member State and has no significant income in his Member State of residence, he is, for the purposes of taking into account his ability to pay tax, in a situation objectively comparable, with regard to his Member State of employment, to that of a resident of that Member State who is also in salaried employment there. It is apparent that such a person, not being liable in his Member State of residence to pay tax applicable to natural persons in respect of income from immovable property other than the property tax paid in advance, is not able to have the negative income relating to his immovable property in that Member State taken into account and, moreover, is deprived of any possibility of setting off that negative income in the determination of the basis of taxation of his taxable income in his Member State of employment"*[1417]. As a result, the ECJ concludes that the free movement of workers requires that, in a situation such as that of Mr Renneberg, negative income related to a dwelling in the residence State should be taken into account by the tax authorities of the work State for the purposes of determining the taxable base in the latter State.

In this regard, the ECJ further remarks that the extension by the Netherlands of resident treatment to non-residents earning (almost) all of their income in the Netherlands does not affect Belgium's right's under the tax treaty and does not impose any new obligation on it. Furthermore, the ECJ observes[1418] that, in order to avoid discrimination, the mechanisms used to eliminate or alleviate double taxation must permit the taxpayers in the Member States concerned to be certain that, ultimately, all their personal and family circumstances will be duly taken into account, irrespective of how those Member States have allocated that obligation amongst themselves. Given the *Lakebrink*-interpretation of the *Schumacker*-doctrine, those considerations also apply with regard to the taking into account of workers' overall ability to pay tax[1419].

[1416] C-527/06, *Renneberg*, § 57-58.
[1417] C-527/06, *Renneberg*, § 66-67.
[1418] Referring to C-385/00, *De Groot*, § 101.
[1419] C-527/06, *Renneberg*, § 69-70.

Finally, the ECJ dismissed the argument of the Dutch government that the disadvantage incurred by Mr Renneberg was due to a disparity between the internal tax systems of Belgium and the Netherlands (see 2.E.II).

Comparison with Lakebrink and conclusion

Given the similarities, *Renneberg* calls for a comparison to *Lakebrink.* As indicated earlier, the ECJ decided in *Lakebrink* that the negative rental income relating to property situated in Germany, the State of residence of Mr and Mrs Lakebrink, had to be taken into consideration for the purposes of determining the **tax rate** applicable to the employment income that was entirely earned in Luxembourg, their work State. The difference with *Renneberg* is that the latter case concerns the **taxable base**. In his opinion in *Lakebrink*, Advocate-General Mengozzi also stressed that the rule at issue in *Lakebrink* only related to the calculation of the tax rate and not the determination of the taxable base. The Advocate-General thus observes that requiring the work State, when it calculates the tax rate, to grant benefits related to the non-resident's ability to pay (including benefits linked to the management of assets where the work State does not have the power to tax the income from such assets), does not imply that the work State is taxing that income. As a result, the allocation of taxing powers under the applicable tax treaty remained unaffected in *Lakebrink*[1420]. The situation was different in *Renneberg*, as the rule at issue did concern the taxable base. However, the reason why the Court nevertheless reaches the same conclusion as in *Lakebrink* has been pointed out above: the Netherlands took account of the negative income when determining the taxable base of **its own residents**. When a State does so (either unilaterally or pursuant to the provisions of a tax treaty, as was the case in *Renneberg*), it can no longer invoke the allocation of taxing powers as precluding the discrimination-test[1421].

Assuming that this distinction can be extrapolated to other cases, the general tenet seems to be that elements relating to the tax rate follow the *Schumacker*-approach. In principle, elements relating to the taxable base do not fall under this approach, as this aspect is governed by the allocation of taxing powers under the applicable tax treaty (excluding it from the Court's discrimination-test). However, if the Member State in question takes these elements into account when determining the taxable base of its own residents, the allocation of taxing powers is no longer relevant, which means that the discrimination-analysis (and, thus, the *Schumacker*-doctrine) can be applied.

To sum up, the Court has extended its *Schumacker*-style reasoning to domestic tax measures relating to negative income from foreign immovable property. In my opinion, that is entirely correct. As will be discussed in 2.E.I.A.b.1.d, non-discrimination essentially seeks to ensure that taxpayers with an identical ability to pay tax carry the same tax burden. One of the elements taken into account in that respect is the taxpayer's personal and family situation (e.g. whether he is married). However, there are also other elements that determine a taxpayer's ability to pay tax. In particular, a taxpayer's ability to pay is also determined by his worldwide income: the more income, the higher his ability to pay tax. So the existence of negative income from immovable property also contributes to a taxpayer's ability to pay. Accordingly, if a Member State takes account of such negative income where its residents are concerned, it must also do so with respect to non-residents insofar as they are comparable to residents.

[1420] Opinion of Advocate-General Mengozzi in C-182/06, *Lakebrink*, § 40.
[1421] See also M. LANG, "Recent case law of the ECJ in direct taxation: trends, tensions and contradictions", *EC Tax Review* 2009, 103.

However, there is a problem with the *Schumacker*-doctrine itself. As discussed above, that doctrine allows the Court to assess whether taxpayers have an identical ability to pay tax. But as will be pointed out hereafter, the way it does so is not entirely correct.

c. Should Schumacker be overturned?

1. The problem with Schumacker

Perhaps the most important objection against the *Schumacker*-doctrine concerns the fundamental idea underlying it, that non-residents become comparable to residents when they earn almost all their income in the host State, at which moment they are entitled to person-related benefits. Consequently, non-residents are only entitled to national treatment in respect of those benefits when they earn most of their income in the host State. Several commentators have argued that this approach is incorrect and discriminatory in itself. As a consequence of the very fundamental distinction in international tax law between worldwide taxation of residents and limited taxation of non-residents (and the approach taken by most Member States to grant residents a reduction to prevent international double taxation on the basis of a *pro rata parte* allocation of the amount of home State tax on the domestic and the foreign-source income) any cross-border worker or entrepeneur is faced with a partial loss of person-related benefits[1422] [1423]. For instance, a frontier worker earning 50% of his income at home and 50% in the host State loses 50% of the tax benefit of the home State personal allowances. As he does not reach the *Schumacker*-threshold, he is not entitled to those allowances in the host State. According to these authors, this internationally accepted proportional method of calculation of the home State tax attributable to foreign-source income is an impediment to the freedom of movement which should be eliminated by the host State. Therefore, the obligation resulting from *Schumacker*, i.e. that the host State must grant its personal allowances to certain non-residents, should be extended on a *pro rata* basis to all non-residents[1424]. Put briefly, the home State is allowed to limit the person-related benefits in proportion to the home State income, but the host State should adopt the method of 'fractional residence taxation' of non-residents[1425].

[1422] On the other hand, a taxpayer earning part of his income abroad also enjoys a benefit, in that he avoids progressive taxation on his foreign-source income. As the income is split between two (or more) States, progression is generally lower than where a taxpayer earns all his income in one State. Cf. also 2.E.I.B.c.5, on the disadvantage-issues in *Asscher*.

[1423] This is the case both for systems of double taxation relief on the basis of the exemption method and the credit method. In both methods, the reduction of home State tax to prevent double taxation of foreign-source income is calculated on a pro rata basis, i.e. by applying a fraction, the numerator of which is the foreign-source income and the denominator of which is the worldwide income. In both systems, the person-related benefits are allocated to the domestic income and therefore proportionally lost if a taxpayer earns part of his income abroad. Calculation examples will be given below.

[1424] E.g. W. KAEFER, "Neuregelung der Besteuerung Nichtansässiger im Grenzpendlergesetz II", *Betriebs-Berater* 1995, 1621; P. WATTEL, "Progressive taxation of non-residents and intra-EC allocation of personal tax allowances: why Schumacker, Asscher, Gilly and Gschwind do not suffice", *European Taxation* 2000, 210; A. CORDEWENER, "Personal income taxation of non-residents and the increasing impact of the EC Treaty freedoms", in D. WEBER, *The influence of European law on direct taxation*, Alphen aan den Rijn, Kluwer Law International, 2007, 68; K. VAN RAAD, "Non-residents – personal allowances, deduction of personal expenses and tax rates", *World Tax Journal* 2010, 154-161.

[1425] This term was coined in C. VAN RAAD, "Fractionele belastingheffing van EU buitenlandse belastingplichtigen" in J. VERBURG (ed.), *Liberale gifte: vriendenbundel Ferdinand Grapperhaus*, Deventer, Kluwer, 1999, 297-305.

When the Court decided *Schumacker*, it most likely presumed that taxpayers working abroad already get their person-related benefits in their home State, which means that the host State is normally not required to grant its benefits to those non-residents[1426]. The Court limits the host State's responsibility to situations where the taxpayer earns (almost) all of his income in the host State. However, that presumption is not entirely correct, as the taxpayer working abroad only receives a part of the person-related benefits in his home State, proportionate to the income arising in his home State. Due to the particular facts of the *Schumacker*-case (the taxpayer earned no income in his home State and his income from the host State was entirely exempt in his home State), the case was ultimately decided correctly but the Court's fundamental misunderstanding of this aspect of international tax law paved the way for the questionable direction in which the *Schumacker*-doctrine would be headed.

The general idea which functions as the starting point for the *Schumacker*-doctrine is that a taxpayer's personal life is concentrated in his home State. Therefore, his personal circumstances should be taken into account there, and not in the host State. The exception to that rule is the situation where the taxpayer earns (almost) all his income in the host State, in which case the host State should fully grant its personal allowances. Several Member States have implemented this idea by providing for a 90%-rule: non-residents who earn more than 90% of their worldwide income in the host State will be treated as residents there in respect of personal allowances. Of course, such a 90%-threshold is arbitrary. For instance, a taxpayer earning 95% of his worldwide income in the host State is entitled to 100% of the personal allowances there. Moreover, he enjoys 5% of the personal allowances in his home State. In contrast, a taxpayer earning 89% of his worldwide income in the host State is not entitled to any personal allowances in the source State, since he does not meet the 90%-threshold. In his home State, this taxpayer is only entitled to 11% of the personal allowances. The vast difference in treatment between these two taxpayers, whose factual circumstances are very similar, demonstrates the arbitrary nature of the 90%-rule and the severe consequences thereof.

An example may illustrate the issues set out above. The taxpayer, a State A resident earns 15,000 in State A and 10,000 in State B. The income tax due in State A is calculated as follows. First, the taxpayer's worldwide income is calculated (25,000). State A then grants

[1426] More precisely, the ECJ apparently assumes that home States always allocate personal allowances entirely to the domestic part of their residents' income. *Schumacker* entails that the host State is only required to grant personal allowances if the home State is unable to do so, i.e. if the taxpayer earns (almost) all his income in the host State. If the domestic portion of the taxpayer's income is sufficient to set off all personal allowances, there is thus no need for the host State to intervene. However, home States do not allocate personal allowances entirely to domestic income, but rather to worldwide income. As a result, part of the personal allowances are lost if a taxpayer earns income abroad (cf. supra). This assumption is particularly clear in *Gschwind*, § 28-29, in which the Court holds that Mr Gschwind's situation differs from that at issue in *Schumacker*. Neither Mr Schumacker nor his spouse had any significant income in their State of residence allowing account to be taken of their personal and family circumstances. Mr Gschwind's situation was different, as it was possible to take *"into consideration, **on a sufficient tax base**, […] the personal and family circumstances of taxpayers in the State of residence. In the present case, given that nearly 42% of the total income of the Gschwinds is received in their State of residence, that State is in a position to take into account Mr Gschwind's personal and family circumstances according to the rules laid down by the legislation of that State, **since the tax base is sufficient there to enable them to be taken into account.**"* The Court thus seems to assume that, as soon as the income earned in the home State is higher than the personal allowances available there, the taxpayer will always be able to fully benefit from the personal allowances in his home State. However, this assumption is not entirely correct: home States generally allocate personal allowances to the worldwide income on a pro rata basis, which means that taxpayers earning income abroad can only partially enjoy the personal allowances in their home State. Cf. also P. WATTEL, "Progressive taxation of non-residents and intra-EC allocation of personal tax allowances: why Schumacker, Asscher, Gilly and Gschwind do not suffice", *European Taxation* 2000, 217-218.

reductions to take account of the taxpayer's personal and family circumstances, for instance 2,500. Accordingly, an amount of 22,500 is taxable in State A. Assuming that the average tax rate in State A is 40%, an amount of tax of 9,000 is due. However, State A grants relief for double taxation to the amount of 3,600 (10,000 / 25,000 * 9,000). After relief, an amount of 5,400 is due in State A. Assuming that the average tax rate in State B is 40% as well, the taxpayer pays an overall tax of 9,400 (5,400 + 4,000). State B does not grant any person-related benefits as he does not meet the 90%-threshold.

If the taxpayer had earned all his income in State A, he would have paid 9,000 on his total income, which is 400 less than in the cross-border situation. This is exactly the amount of personal benefits allocated to the income earned in State B. The proportion of income earned in State B is 10,000 / 25,000 = 0.4. A portion of 0.4 of the personal benefits of 2,500 is 1,000. After application of the State A tax rate of 40%, the result is 400. Because 40% of the income is earned abroad (and therefore exempt in State A), 40% of the personal benefits are lost. The greater the proportion of income earned abroad, the greater the disadvantage (until the 90%-threshold is met).

The question thus arises which State is required to remedy this problem. In my opinion, the home State cannot be blamed for proportionally restricting its personal allowances to the income earned at home. Person-related benefits cannot be allocated to a specific part of the income, since they are linked to the person of the taxpayer. These benefits are not instrumental in generating (a specific part of) the taxpayer's income; they are solely intended to take account of his personal ability to pay. Therefore, these allowances weigh on the taxpayer's global income and should be (proportionally) divided among the jurisdictions in which he earns that income. From the perspective of the source State, the mirror image of this argument is that it should (proportionally) grant its own allowances to non-residents earning part of their income there. Not doing so would be discriminatory, as residents are entitled to a pro rata grant of these allowances.

The reason why source States do not grant non-residents a pro rata entitlement to personal allowances is that they do not have sufficient information in respect of these personal circumstances and the taxpayer's worldwide income. As a result, the source State is unable to determine how much of its personal allowances it should grant to the non-resident in question. The solution to this problem is for the source State to require the non-resident taxpayer to report his worldwide income and provide information on his personal circumstances. This would obviously create some administrative nuisances for the source State, but, given the Court's case law in this area, it is clear that those nuisances are not sufficient to justify the discrimination[1427]. In fact, requiring the non-resident taxpayer to report his worldwide income would not only allow the source State to grant the correct proportional amount of personal allowances, it would also remove the progression benefit, as the source State would be able to apply the correct progression in the applicable tax rate[1428]. From the perspective of non-discrimination, this approach is to be applauded, as it ensures that the same regime (i.e. a pro rata entitlement to personal allowances) is applied to residents and non-residents.

As mentioned in 2.E.I.A.b.1.a.6, the ECJ suggested in *De Groot* that the residence State should allocate the person-related benefits entirely to the taxpayer's domestic income. In the

[1427] E.g. C-204/90, *Bachmann*, § 17-18; C-1/93, *Halliburton*, § 21-22; C-279/93, *Schumacker*, § 43-45; C-520/04, *Turpeinen*, § 35-37. See also 2.E.I.A.b.8.

[1428] Cf. P. WATTEL, "Progressive taxation of non-residents and intra-EC allocation of personal tax allowances: why Schumacker, Asscher, Gilly and Gschwind do not suffice", *European Taxation* 2000, 215, 222.

relief formula, the allowances must therefore be deducted from the denominator of the fraction. Under this approach, the disadvantage in the example given above would effectively disappear. The relief granted in State A would increase to 4,000 (10,000 / 22,500 * 9,000). As a result, the overall tax burden would be 9,000 (5,000 in State A + 4,000 in State B). This is precisely the same amount of tax as the taxpayer would have paid if he had earned all his income in State A, which means that the disadvantage is entirely removed.

Moreover, this approach might work in favour of taxpayers working abroad. Assume, for instance, that the taxpayer in the example earns 5,000 in State A, 4,000 in State B and is entitled to person-related allowances of 6,000 in State A. The worldwide income of 9,000 would be reduced by the allowances of 6,000, resulting in 3,000. On this income, an amount of State A tax of 1,200 is due. After relief in State A (which amounts to 533.33), the tax due in State A is 666.67. Accordingly, the overall tax due is 2,266.67 (666.67 in State A + 1,600 in State B). This results in a disadvantage of 1,066.67 for the taxpayer. Applying the Court's approach in *De Groot*, would result in an amount of relief in State A of 1,600 (1,200 * 4,000 / 3,000). In the end, the taxpayer would pay a total amount of tax of 1,600: the relief given in State A will be limited to the tax levied there (1,200), as State A will not refund taxes levied abroad. However, the excess of 400 will be carried over to subsequent years in order to increase the reduction in those years, which means that the net result will be 1,200, i.e. precisely the same amount of tax as the taxpayer would have paid if he had earned all his income in State A.

Even though this solution entails neutral treatment for the taxpayer working abroad as compared to a purely domestic situation, it is submitted that it is incorrect from a non-discrimination perspective. Requiring the residence State to abolish its proportional system of person-related benefits goes beyond what non-discrimination requires and is in fact a policy choice[1429]. Member States should be free in designing their tax regime, including the choice for a proportional limitation of person-related benefits. But once they have made a choice, they should apply the system in a non-discriminatory manner. That is to say, when a Member State grants benefits to its residents on a pro rata-basis, it should do the same for non-residents. When it does not grant any benefits to its residents, there is nothing to prevent it from refusing those benefits to non-residents.

What the Court says in *De Groot* boils down to a requirement for the State of residence to fully grant its person-related allowances to residents working abroad, regardless of the division of income between work State and home State (unless the *Schumacker*-threshold has been reached). This has little to do with non-discrimination. Rather, it is a policy choice, in that the ECJ requires the home State to remove double taxation even though the former

[1429] As a side note: requiring the host State to grant neutral treatment to non-residents would be inconsistent from a non-discrimination perspective. More specifically, neutral treatment implies a comparison to similar taxpayers earning all their income in the home State. Neutral treatment of a cross-border situation therefore implies that the tax burden on the taxpayer earning income in another State is identical to the tax burden on the taxpayer earning all his income in that taxpayer's home State. However, when applying the non-discrimination test to the host State, the comparison is made to residents (or nationals) of that State. Discrimination arises in the host State when that State does not grant national treatment to non-residents who are comparable to residents. The disadvantage that should be removed by the discriminating host State is therefore not the lack of neutrality encountered by the non-resident, but the lack of national treatment in the host State. The host State is not required to guarantee neutrality as compared to the domestic situation in the home State, but only neutral (i.e. national) treatment as compared to its own residents.

Article 293 EC did not have direct effect and double taxation, as such, is not contrary to the fundamental freedoms[1430].

2. The credit system as an alternative solution?

It has also been suggested that a better approach would be for all Member States to adopt the credit system as it is applied in the U.K., since the problems described above all stem from defects in the exemption system[1431]. A taxpayer working abroad would then effectively pay the same tax as if he continued to work in his home State. Full personal allowances would be granted in the home State, as these are given before calculating the credit for the tax on foreign income[1432].

Under a credit system, the calculation in *Gilly* would be as follows:

Net worldwide income	=	300,000
Tax due in France	=	64,643
Income taxed in Germany	=	165,000
Tax due in Germany	=	39,669
Total tax due	=	104,312
Relief given by France	=	39,669
Total tax due after relief	=	64,643

The disadvantage would thus disappear completely: the taxpayer no longer incurs an advantage by reason of his cross-border activity. However, this approach is not entirely satisfactory, for several reasons. First, the examples given earlier should demonstrate that the problems are not caused by inherent defects in the exemption system, but rather by the inconsistent application by the host States of their regime. In particular, States generally apply worldwide taxation and proportionate relief when they act as home States, but a consistent approach requires them to do the same when they act as host States (i.e. worldwide taxation and proportionate relief for non-residents). Secondly, in order for all Member States to implement a credit system, harmonisation of the national systems is required. However, such positive integration is most likely at odds with the subsidiarity principle of Art. 5 TEU (former Art. 5 EC), according to which, the Union, in areas which do not fall within its exclusive competence, can only act if and insofar as the objectives of the proposed action cannot be sufficiently achieved by the Member States.

[1430] E.g. C-336/96, *Gilly*, § 14 *et seq.* and 2.E.I.A.b.6.
[1431] E.g. J. AVERY JONES, "A comment on 'Progressive taxation of non-residents and intra-EC allocation of personal tax allowances'", *European Taxation* 2000, 375.
[1432] It is submitted that this is not relevant to the problem at hand. In the exemption method, the benefits are also granted before calculation of the relief for foreign income. The problem is the subsequent loss of a proportional part of those benefits when the relief is calculated. In the example given when discussing *Gilly*: 55% of the person-related benefits was lost because that proportion was attributed to the German income. In general, the same proportional limitation applies under credit systems: the amount of credit is limited to the amount of home State tax attributable to the foreign income, which is calculated as a proportionate part of the total tax due (i.e. at the average rate). As that attributable amount of tax is reduced by person-related deductions from income, the credit is also reduced (which entails a proportionate loss of those deductions). Cf. J. AVERY JONES, "A comment on 'Progressive taxation of non-residents and intra-EC allocation of personal tax allowances'", *European Taxation* 2000, 377.

Arguably, requiring Member States to switch to a credit system would go beyond what is necessary to ensure free movement. Given their sovereignty in matters of direct taxation, Member States should remain free to choose a relief system. After having chosen a system, they must however apply it in a non-discriminatory manner. The fractional approach, detailed above, ensures non-discriminatory treatment. Moreover, obliging Member States to adopt a uniform credit system goes beyond what is necessary because it aims to achieve complete neutrality as compared to the domestic situation. However, the fundamental freedoms are essentially based on an idea of the prohibition of discrimination (be it direct or indirect). Rather than compelling home States to ensure non-restrictive treatment, they oblige host States to ensure non-discriminatory treatment (i.e. as compared to their own residents or nationals). Absolute neutrality (i.e. non-restriction) in this context can only be attained through positive integration (see also 2.D.V).

Finally, it has been suggested that the fractional approach is not a workable solution for the ECJ because it would go beyond the Court's judicial role[1433]. More specifically, requiring host States to grant a pro rata part of their person-related benefits would require legislative action (i.e. positive integration) rather than negative integration. However, it should be stressed once more that the proposed fractional approach is nothing more than an aplication of the national treatment-principle underlying the fundamental freedoms. Only if the host State applies a pro rata-system of personal benefits to its own residents, it should extend this system to non-residents. States are therefore not asked to harmonize their national systems according to a certain model: they are only required to grant national treatment to non-resident workers[1434].

3. Fractionality and comparability

Assuming that the *Schumacker*-doctrine should indeed be replaced by a fractional approach, what does that mean for comparability? The reasoning in *Schumacker* was based on the idea that when a non-resident earns almost all his income in the host State, a switch is triggered which renders him comparable to a resident. In other words, there is a certain threshold below which non-residents are incomparable and above which they are comparable to residents. In contrast, under the proposed fractional approach, there is no switch which renders the situations comparable. Instead of a binary approach (i.e. either 0 or 1, either incomparable or comparable), there seems to be a sliding scale of comparability, under which the situations become more comparable as the income is more concentrated in the host State. The more income the non-resident earns in the host State, the more he is entitled to national treatment. Yet, such an idea of proportional comparability is problematic, both from a conceptual as from a practical perspective[1435].

As a first solution to this problem, the fractional residence-approach could be applied as an aspect of the justification-test. In that case, the fractionality would be the translation of the proportionality-requirement for the relevant justification-ground. More specifically, when the Court is asked whether a Member States discriminates against a non-resident working there when that Member State does not fully grant the non-resident personal allowances, the main question is no longer whether the non-resident earns enough income to be comparable to a resident but rather whether the denial of the benefits is proportionate. The justification (the amount of income not earned in the source State) must thus be proportionate to the

[1433] P. FARMER, "EC law and national rules on direct taxation: a phoney war?", *EC Tax Review* 1998, 19.
[1434] Compare this to the point made in 2.E.I.A.b.6: Member States are required to prevent double taxation on inbound dividends to the extent that they prevent double taxation on domestic dividends.
[1435] See also 2.F.II.

disadvantage incurred by the non-resident (the amount of personal allowances not granted in the source State). The more income the non-resident earns in the source State, the more personal allowances he is entitled to in that State. The applicable regime would therefore only be justified if non-residents are granted person-related benefits on a pro rata basis, in relation to the amount of income earned in the source State.

From the perspective of comparability, this would be a complete reversal of *Schumacker*. The comparability-test no longer starts from the assumption that, in respect of direct taxation, residents and non-residents are generally incomparable. Instead, the basic approach is that they earn the same type of income in the same State and are therefore comparable. This is in line with the Court's general case law in matters of indirect discrimination. Not only direct discrimination on the basis of nationality is prohibited, but also indirect discrimination on the basis of residence. Accordingly, a distinction between residents and non-residents is, as a rule, prohibited. There is no reason to use a different starting point in matters of direct taxation than in other areas.

However, the idea that the fractional approach implies proportional comparability is incorrect. The comparison is not made between a non-resident earning part of his income in the source State, and a resident earning all of his income there. In that case, the analysis would be one of proportional comparability, in that the non-resident would be 'proportionally comparable' to the resident.

Instead, the comparison in the fractional approach is made between a non-resident who earns a certain percentage of his income in the source State, and a resident of the source State who earns the same percentage of his taxable income in that State. The comparative attribute is the amount of income earned in the source State. If that attribute is identical among subject and object of comparison, the subject of comparison is entitled to national treatment as regards tax consequences of ability to pay. Accordingly, if the source State limits entitlement to person-related benefits on a pro rata basis for its residents, the object of comparison will be entitled to a pro rata part of those benefits (depending on the amount of income earned in that State). As the non-resident is comparable to the object of comparison in this respect, he is entitled to the same pro rata amount of person-related benefits. Obviously, this is not a matter of proportional comparability. The comparability is still of a binary nature: either the situations are comparable, or they are not[1436].

Finally, as to the Court's extension of the *Schumacker*-doctrine towards negative income from immovable property, the most important criticism has generally been that, from the perspective of the allocation of taxing powers between Member States, profits and losses should be kept together[1437]. The optimal solution to the problem of such negative income is for the host State to take account of the non-resident's worldwide income. As mentioned earlier, the fractional approach requires the non-resident worker to report his worldwide income in the host State, which makes it possible for that State to grant the correct

[1436] As a side note, it should be mentioned that the fractional approach is included in the non-discrimination provision of the tax treaty between Belgium and France, since the 1999 amendment of that treaty. Article 25(2) of the treaty provides: *"personal deductions, allowances and reductions of tax, on account of civil status or family responsibilities granted by the other State to its own residents shall be granted to the persons mentioned in the preceding sentence, but shall be reduced by the ratio of the remuneration arising in that other State to the total professional income, wherever arising, of which the persons are the beneficiaries."*

[1437] E.g. E. KEMMEREN, "ECJ should not unbundle integrated tax systems!", *EC Tax Review* 2008, 7-11. See also E. KEMMEREN, *Principle of origin in tax conventions. A rethinking of models*, Drongen, Pijnenburg Uitgevers, 2001, 507-513.

proportional amount of personal allowances, while at the same time removing the progression benefit. By reporting worldwide income in the host State, the non-resident's negative income from immovable property in another State is also taken into account in the host State, which solves the *Lakebrink*-problem. At the same time, the host State would be able to take account of positive rental income from immovable property in other States. As will be explained in 2.E.I.B.c.7, the government of Luxembourg argued in *Lakebrink* that, overall, the Luxembourg system was favourable towards non-residents. Even though negative income was not taken into account when calculating the Luxembourg tax rate, the same was true for positive income. According to the Luxembourg government, that advantage balanced out the contested disadvantage. The proposed solution of considering the non-resident's worldwide income in the host State resolves both these issues, i.e. the advantage and the disadvantage, thereby providing for an equitable solution.

d. Conclusion

The *Schumacker*-doctrine, and the controversy surrounding it, touches at the very heart of the comparability-test. As mentioned earlier, discrimination is essentially concerned with ensuring that persons with an equal ability to pay carry an equal tax burden. What is thus at stake in the comparability-test, is the comparison of different persons' ability to pay. Ability to pay is essentially based on a philosophy of equal sacrifices: every individual should make an equal sacrifice for the community as a whole. Therefore, the greater a person's ability to pay, the greater his sacrifice should be. This sacrifice is represented in practice by the tax burden carried by the individual. Accordingly, every person with an equal ability to pay (comparability) should carry an equal tax burden (equal treatment).

This analysis is fairly simple to carry out in a strictly domestic context. However, matters are significantly complicated when another State is involved. The question then arises whether the same criterion (ability to pay) should be used as the basis for the comparison. In other words, is this criterion equally relevant in a cross-border situation when determining what non-discriminatory treatment implies? The optimal solution would then be that a taxpayer carries a tax burden in each State that is proportional to the amount of income he earns in that State[1438]. That solution is achieved by the fractional approach, discussed above. As pointed out earlier, the ECJ's *Schumacker*-solution does not succeed in finding a perfect correlation between ability to pay and tax burden: the idea that residents and non-residents suddenly become comparable when a certain threshold is met (and the resulting shift as to the obligation of taking personal and family circumstances into account), is difficult to reconcile with the idea that an equal ability to pay in a certain Member State (as expressed by the amount of income derived in that State) should result in an equal tax burden in that State.

Additionally, it might be difficult in practice to distinguish between ability to pay and tax burden. The *Schumacker*-case law reveals that this distinction is particularly confusing as regards the taxpayer's personal and family circumstances. Apparently, the ECJ considers these circumstances to be part of both ability to pay and tax burden. The *Schumacker*-reasoning goes as follows: residents and non-residents are generally not comparable because a non-resident's personal **ability to pay tax**, determined by reference to his **aggregate income**

[1438] As mentioned earlier, a taxpayer's total amount of income is not a perfect indicator for his ability to pay tax, even if that ability to pay is nuanced by granting him benefits relating to his personal situation. However, it is accepted for the time being that there is no viable alternative to that indicator, particularly taking into account that the amount of income allows a taxpayer's ability to pay to be expressed as a mathematical value, which makes it possible to compare to another taxpayer's ability to pay.

and his **personal and family circumstances**, is more easy to assess at the place where his personal and financial interests are centred (i.e. his State of residence). It is therefore up to the State of residence to take account of a taxpayer's **personal and family circumstances**. In contrast, where the taxpayer earns the major part of his income in the work State, the State of residence is not in a position to grant those benefits, and EU tax law requires the work State to take account of the **personal and family circumstances** of the non-resident into account in the same way as those of residents. Put briefly: as residents and non-residents are generally incomparable, the source State is not required to ensure an equal tax burden for non-residents (which, in the case at issue, particularly concerns the taking into account of personal and family circumstances). In the exceptional situation where they are comparable, the source State must guarantee an equal tax burden (i.e. must take account of personal and family circumstances in the same way as those of residents).

In the Court's reasoning, ability to pay is thus determined by aggregate income and personal and family circumstances. When residents and non-residents are comparable (i.e. when their ability to pay is identical), their tax burden should be the same. In *Schumacker*-style cases, the element of tax burden at issue was the taking into account of personal and family circumstances. This might seem confusing, but it must be stressed that the comparability-test (i.e. the ability to pay) is only concerned with the **existence** of personal and family circumstances (e.g. whether the taxpayer is married, whether he has children, etc.) while the disadvantage-test (i.e. the tax burden) concerns the **consequences** of these circumstances, i.e. the benefits granted in relation to those circumstances.

The same approach can be taken with respect to the extension to *Schumacker* brought about by *Ritter*, *Lakebrink* and *Renneberg*. In such cases as well, a fractional approach is preferable from the perspective of comparability. Yet, the particular role of tax treaties in those cases should be stressed. More specifically, all those cases involved income from immovable property which, under the applicable tax treaties, was exclusively taxable in the State where it was situated. For that reason, it could be suggested that the other Member State should not be required to grant benefits relating to that property, since it cannot tax the related income. However, the Court draws a distinction in this regard between benefits relating to the taxable base and benefits relating to the tax rate.

1. As to the former category of benefits, *Renneberg* is illustrative. In that case, non-residents were unable to reduce their **taxable base** with negative income from immovable property situated in Belgium. In principle, however, the Belgian/Dutch tax treaty precludes the Netherlands from taxing immovable property situated in Belgium. Given that allocation of taxing powers, it is up to the State where the property is situated (Belgium) to take account of the related benefits relating. If that State chooses not to do so, the disadvantage incurred by a taxpayer who will not be granted the benefits in either State[1439] is due to a disparity. That is to say, in designing their tax systems Member States remain free to decide whether or not they grant specific benefits, on the condition that they do so in a non-discriminatory manner.

The reason why *Renneberg* was ultimately decided differently, was that the tax treaty did **not** preclude the Netherlands from taking account of negative income from immovable property situated in Belgium: the tax treaty expressly allowed the Netherlands, when determining the taxable base of its residents, to take account of (negative) income from immovable property situated in Belgium. For that reason, the disparity-defence could not be upheld. Since the tax

[1439] As compared to a resident of the Netherlands who owns immovable property there and is able to reduce his taxable base in the Netherlands with negative income from that property.

treaty did not prevent the Netherlands from taking account of negative income from immovable property situated in Belgium, and since the Netherlands effectively did so as regards its own residents, the refusal to do so as regards non-residents constituted discrimination. Thus, the discrimination could be removed either by allowing non-residents to take account of foreign negative income from immovable property **or** by disallowing residents to take account of such foreign negative income. In the latter case, the discrimination is removed as well, since neither residents nor non-residents are able to take foreign negative income from immovable property into account (even though the tax treaty would not preclude such income from being taken into account in the Netherlands)[1440].

> It should also be noted that the Court in *Renneberg* stresses the fact that the negative income from the immovable property situated in Belgium could not be taken into account in Belgium[1441]. The position of this argument in the Court's reasoning may seem misleading, and suggest that it affects the comparability of the situations. Indeed, the fact that no benefit is granted in Belgium should only determine whether there is a disadvantage: if the Belgian resident was entitled to a similar benefit in his home State, there would be no disadvantage in the Netherlands and, therefore, no discrimination. As will be pointed out in 2.E.I.B.c, however, the Court has consistenty dismissed arguments pertaining to counterbalancing effects of advantages granted by the domestic laws of another State. Applied to the present issue, the discrimination caused by the Netherlands should therefore be considered in isolation from potential benefits granted by Belgium.
>
> Yet, the reason why that aspect was stressed in *Renneberg*, is arguably related to the philosophy underlying *Schumacker*. As discussed earlier, *Schumacker* starts from the assumption that a taxpayer generally earns the majority of his income in his home State, with the result that that State is in the best position to grant him personal and family benefits. For that reason, residents and non-residents are generally not comparable in the context of those benefits. The situation is different where a non-resident receives no significant income in his State of residence and obtains the major part of his taxable income in another Member State, with the result that his home State is not in a position to grant him those benefits. In such a case, Court considers the non-resident to be comparable to a resident. Put briefly, the inability of the home State to grant the benefits is the **reason** why non-residents earning most of their income in another Member State State are comparable to residents of the latter State.
>
> Similarly, in *Renneberg*, the taxpayer earned the majority of his income in the work State (the Netherlands), while the residence State (Belgium) did not grant the benefit related to the immovable property situated there. Strictly speaking, the allocation of taxing powers as laid down in the tax treaty meant that Belgium was able to grant that benefit, but it chose not to do so. Indeed, the immovable property was situated in Belgium with the result that the tax treaty allowed Belgium to tax the income. As pointed out above, the Netherlands cannot, in principle, be blamed from the disadvantage resulting from the fact that Belgium did not do so. However, since the tax treaty did not preclude the Netherlands from taking account of the negative

[1440] The Netherlands seems to have taken the latter approach: as of 2001, residents are no longer able to take negative income from immovable property situated abroad into account (see R. FROGER, "Hypotheekrenteaftrek voor niet-ingezetenen van Nederland", *Internationale Fiscale Actualiteit* 2010, 3, 6).

[1441] C-527/06, *Renneberg*, § 67: *"It is apparent that such a person, not being liable in his Member State of residence to pay tax applicable to natural persons in respect of income from immovable property other than the property tax paid in advance, is not able to have the negative income relating to his immovable property in that Member State taken into account"*.

income, and since it effectively did so as regards residents, it would be discriminatory for the Netherlands not to extend that benefit to non-residents.

In conclusion, therefore, the fact that Belgium did not grant the benefits was irrelevant for the issue in *Renneberg*. The disadvantage resulting from that fact was due to a disparity and therefore goes beyond the scope of the Treaty freedoms. The actual discrimination was due to the fact that the Netherlands allowed residents to take account of negative income from immovable property situated in Belgium while non-residents were unable to do so. The fact that those non-residents were unable to obtain any benefit in Belgium only underscored the effects of that discrimination. For that reason, the apparent parallel with *Schumacker* is misleading: in *Schumacker*-situations, the home State is unable to grant the benefits because of a lack of taxable income, while in *Renneberg*, the home State was able to grant the benefits but chose not to do so. In other words, this aspect does not affect the comparability of the situations. What it ultimately comes down to is that the Netherlands tried to argue that the disadvantage was due to the allocation of taxing powers in the tax treaty. Belgium had the exclusive power to tax income from immovable property situated there and should therefore take account of negative income arising therefrom. The fact that Belgium chose not to do so resulted in a disparity. But the actual problem was that the Netherlands was able to grant these benefits under the treaty and effectively did so as regards its own residents.

2. With respect to the latter category of benefits, relating to the tax rate, the allocation of taxing powers under the tax treaty is not decisive. As Advocate-General Mengozzi noted in his Opinion in *Lakebrink*, the fact that a Member State takes account of (negative) income which is taxable in another State when determining a taxpayer's ability to pay tax for purposes of the tax rate does not mean that the former State is taxing that income. As a result, the allocation of taxing powers under the applicable tax treaty remains unaffected[1442].

In conclusion, therefore, the fractional approach should be taken with respect to all elements pertaining to a non-resident's ability to pay, including his personal and family situations and negative income arising abroad. Consquently, as regards benefits related to that ability to pay, a non-resident is comparable to a resident insofar as he earns the same amount of taxable income in the Member State concerned (fractional approach)[1443]. Given that comparability, the Member State concerned should extend the benefits granted to its residents to such a non-resident. For instance, if residents are entitled to take account of negative income from

[1442] Opinion of Advocate-General Mengozzi in C-182/06, *Lakebrink*, § 40.

[1443] The suitability of the fractional approach is not universally accepted. Instead, some authors adhere to the 'direct link theory', which states that the taxpayer's State of residence should grant person-related benefits because of the personal link which the taxpayer has with that State. By residing in a certain State, a taxpayer agrees to contribute to the financing of that State's administration and the services rendered by that State to taxpayers. For that reason, the residence State is entitled to tax the taxpayer on his worldwide income. As a corollary of this entitlement to tax the worldwide income, that State is also required to grant person-related benefits to its residents, irrespective of where their income is sourced. However, it must be stressed that the reason why the home State grants person-related benefits to its residents is precisely because the home State taxes its residents on a worldwide basis, i.e. because there is an assumption that their ability to pay is centered in the home State. But that is not entirely accurate: the mere fact that a resident is liable to tax on his worldwide income in his home State does not mean that his ability to pay (i.e. income) is centered there. So the mere fact that a taxpayer is liable to tax on his worldwide income in his home State does not mean that the home State taxes his total ability to pay. If it is accepted that ability to pay is reflected by the amount of income earned, then the ability to pay may be spread out over a number of States. As a result, the responsibility to take account of personal circumstances will also be spread out over those States. I acknowledge that the fractional approach has certain drawbacks, most notably the administrative difficulties involved, but the ECJ has consistently held that such difficulties are insufficient to justify discriminatory treatment (e.g. C-204/90, *Bachmann*, § 18).

immovable property situated abroad, then non-residents should also be able to do so. If residents are unable to take account of such negative income, then there is no discrimination if non-residents are also unable to do so.

A final point to be addressed is that the Court's case law seems to evolve towards an 'always somewhere' approach, according to which it is necessary that the benefits in question are always granted somewhere. Such an approach has little to do with non-discrimination. As discussed above, non-discrimination requires residents and non-residents to be granted the same benefits insofar as they are in comparable situations. That is what *Schumacker* also comes down to (as unfortunately worded as it may be). Subsequent decisions, such as *De Groot*, seem to indicate that there is a sort of subsidiarity principle that requires a Member State to step in where another Member State has not given the full benefit (for whatever reason)[1444]. But that is not the purpose of the non-discrimination principle. Non-discrimination only requires the benefits to be granted when the situations are comparable. Beyond that, non-discrimination does not require any action on the part of the Member States involved.

> At first glance, there seems to be an additional argument against an 'always somewhere' interpretation in the distinction between the so-called 'per country approach' and 'overall approach'. In particular, it could be said that the 'always somewhere' approach is difficult to reconcile with the Court's traditional position on offsetting advantages. The Court has always been very reluctant to take account of advantages that exist in another Member State and that may offset the disadvantage at issue. The 'always somewhere' approach would not square with that position, since it requires to take account of the taxpayer's overall position in order to assess whether there is a disadvantage. While non-discrimination traditionally considers whether the subject of comparison incurs a disadvantage as compared to a comparable object of comparison (e.g. a resident of the source State), the 'always somewhere' approach implies that the situation of the taxpayer is considered *in abstracto*. Instead of considering whether one Member State discriminates ('per country approach'), the question would be whether the taxpayer ultimately enjoys all the relevant benefits ('overall approach').
>
> However, closer inspection reveals that this is not a valid argument. As will be discussed in 2.E.I.B.d, the ECJ's reluctance to take account of offsetting advantages in other Member States has little to do with a preference for a per country approach, but is merely the logical consequence of the strict conditions that the Court has imposed in order for offsetting advantages to be taken into account, wherever they arise. In other words, the Court makes no distinction between offsetting advantages in the Member State that (allegedly) discriminates and offsetting advantages in another Member State[1445].

[1444] See also C. BARDINI, "The ability to pay in the European market: and impossible sudoku for the ECJ", *Intertax* 2010, 9.

[1445] The Court does not hesitate to take the situation in another Member State into consideration, in particular when assessing whether there is a disadvantage, so it does not seem to have an aversion to the overall approach. For instance, in *Manninen*, the Court considered that non-resident companies paying a dividend to a Finnish resident had already been subject to tax on their profits in their Member State of residence. Since Finland granted relief for underlying tax when the distributing company was a resident (and, therefore, subject to Finnish tax on its profits) but not when the distributing company was a non-resident, there was a disadvantage (see 2.E.I.A.b.6.b.3). So the Court took account of the tax treatment in the other Member State when deciding on the existence of a disadvantage. Similarly, in *Marks & Spencer*, the Court held that the parent company's State of residence should allow for a deduction of losses incurred by a subsidiary established in another Member State insofar as those losses could no longer be taken into account in the latter State (see 2.E.I.A.b.4.d).

2. Income-related benefits: comparability is the general rule

a. Biehl[1446] *and Biehl II*[1447]

Mr Biehl was a German national who resided and worked in Luxembourg. In November of the tax year at issue, he moved to Germany and started working there. For the period from 1 January to 31 October of the tax year, Mr Biehl's Luxembourg employer deducted sums by way of income tax from his salary. Since the amount deducted by the employer exceeded the total amount of his liability to tax, Mr Biehl requested the Luxembourg tax authorities to repay the overdeduction of tax. His request was denied because Luxembourg tax law provided that the tax duly deducted from the wages of taxpayers resident during only part of the year became the property of the Luxembourg Treasury and was not repayable. Mr Biehl argued that this measure gave rise to discrimination because it applied mainly to taxpayers who were not Luxembourg nationals.

The ECJ first referred to its long-standing case law that not only overt discrimination by reason of equality but also all covert forms of discrimination which, by the application of other criteria of differentiation, lead to the same result (see supra, *Sotgiu*). More specifically, the criterion of permanent residence in the Luxembourg territory applied irrespective of nationality, but it could work in particular against taxpayers who are nationals of other Member States.

After *Biehl*, an amendment was introduced in the relevant Luxembourg tax legislation, pursuant to which the benefit was no longer restricted to taxpayers who were resident during the entire year, but was instead made subject to the condition that the taxpayer had been employed on the national territory for a period of at least nine months. Once again, the Court decided that the Luxembourg legislation violated the free movement of workers[1448].

The *Biehl*-case law is the starting-point for the Court's reasoning on income-related benefits (refunds of overpaid wage withholding tax, business expenses, etc.). The general tenet in these cases is that the source State must grant non-residents the same income-related benefits as it grants its own residents. These benefits are connected to the income itself, which is the same for residents and non-residents. Since they are comparable with respect to the relevant characteristic (i.e. the income earned in the source State), different treatment would result in discrimination.

b. Gerritse[1449]

Residents and non-residents are generally comparable with regard to costs that are directly linked to a source of income within the source State. The *Gerritse*-case is the most obvious example of their comparability in that context[1450]. As mentioned in 2.E.I.A.b.1.a.7, the first

[1446] C-175/88, *Biehl*, *ECR* 1990, I-1779.
[1447] C-151/94, *Commission v Luxembourg*, *ECR* 1995, I-03685.
[1448] C-151/94, *Commission v Luxembourg*, § 16.
[1449] C-234/01, *Gerritse*, *ECR* 2003, I-5933.
[1450] As mentioned in 2.E.I.A.b.1.b.1, Advocate-General Léger has suggested that the *Schumacker*-doctrine may also be applied to the place where the taxpayer's total income or losses are taken into account. In other words, the Advocate-General argues that non-residents' ability to pay tax (which depends not only on account being taken of their personal and family circumstances, but also on account being taken of their total income and losses) should not be assessed differently on the sole ground of place of residence, where resident and non-resident taxpayers alike receive all or virtually all their taxable income in the taxing State. As an example, the

issue in that case concerned the impossibility for non-residents to deduct business expenses. The ECJ noted in this regard that *"the business expenses in question are directly linked to the activity that generated the taxable income in Germany, so that residents and non-residents are placed in a comparable situation in that respect"*[1451]. Consequently, a national measure which disallows non-residents to deduct business expenses, whereas residents are allowed to deduct such expenses, constitutes discrimination. As the German authorities had not advanced any grounds to justify the discrimination, the measure was found to violate the freedom to provide services.

c. Conijn[1452]

Mr Conijn was a resident national of the Netherlands, who derived business income in Germany, accounting for less than 90% of his worldwide income. In his tax return in Germany, Mr Conijn deducted from his taxable income the costs he had incurred in obtaining tax advice for the purpose of preparing his tax return in Germany. The German tax administration refused to allow a deduction for that expenditure, because the German income tax legislation provided that non-residents, in contrast with residents, could not deduct from their business income costs incurred in obtaining tax advice. The question arose whether this distinction violated the freedom of establishment.

The ECJ referred to *Gerritse*, where it had held that residents and non-residents are comparable in relation to costs linked directly to the non-resident's income, such as business expenses linked with an activity in another Member State. Applied to *Conijn*, the ECJ held that costs incurred in obtaining tax advice, such as the costs incurred by Mr Conijn in preparing his tax return in respect of income derived in Germany, are directly linked to the income taxed in that Member State because those costs result from the fact that the taxpayer receives income in that Member State. As a result of this direct link, these costs affect in the same way the income received by all taxpayers, whether resident or non-resident.

The German government argued that the possibility for residents to deduct costs incurred in obtaining tax advice was explained by the fact that those costs were made necessary by the complexity of the national tax law. The ECJ dismissed this argument by holding that residents and non-residents are comparable as regards the complexity of national tax law. Consequently, the possibility to deduct those costs must be open to non-residents as well.

d. Scorpio[1453]

Scorpio, a German resident company which organised concerts, concluded a contract with Europop, a Netherlands resident individual that made a music group available to Scorpio. Under German tax law at the material time, non-residents were liable to tax in Germany on income from cultural, artistic or similar performances in Germany. This tax was levied by means of retention at source, amounting to 15% of the total income. Business expenses were

---

Advocate-General refers to the part in the ECJ's decision in C-234/01, *Gerritse*, *ECR* 2003, I-5933 dealing with the deduction of business expenses. See Advocate-General Léger's opinion in C-152/03, *Ritter-Coulais*, *ECR* 2006, 1711, § 98. However, this aspect of *Gerritse* was not an actual application of the *Schumacker*-doctrine. Rather, the idea behind this aspect of *Gerritse* was that residents and non-residents are generally comparable as regards costs which are directly linked with the taxable income at issue.

[1451] C-234/01, *Gerritse*, § 27.

[1452] C-346/04, *Conijn*, *ECR* 2006, I-6137, 6 July 2006.

[1453] C-290/04, *FKP Scorpio Konzertproduktionen GmbH*, *ECR* 2006, I-09461, 3 October 2006.

not deductible. The tax was withheld by the debtor when the payment was made to the service provider. The debtor was responsible for retaining the tax and paying it to the German tax authorities. Afterwards, the service provider could request to be taxed on the basis of his net income, thus obtaining a refund of overpaid tax.

In contrast, a German resident service provider declared his income in the general assessment procedure. In his declaration, he could deduct business expenses. Moreover, since the debtor of the payment was not obliged to withhold tax at source, he could not incur liability by reason of not having made the retention, nor could he be held liable for the income tax due from the service provider. Scorpio argued that this difference in treatment violated the freedom to provide services because business expenses where not deductible in the case of payments made to non-resident service providers, whereas resident service providers where taxable only on their net income.

The ECJ first refers to *Gerritse*, in which the business expenses in question were directly linked to the activity that had generated the taxable income, so that residents and non-residents were comparable in that respect. Accordingly, the refusal for non-residents to deduct business expenses, whereas residents were allowed to to so, was discriminatory. The Court immediately observes, however, that the *Gerritse*-judgment did not rule *"on the question of the stage of the taxation procedure at which the business expenses incurred by a provider of services must be deducted, in a case where several different stages are possible"*. The ECJ then notes that the relevant expenses within the meaning of the *Gerritse* case law are 'economically connected business expenses', i.e. expenses that are directly linked to the economic activity that generated the taxable income[1454].

> In respect of this definition, it should be pointed out that the Court has also decided that the place and time at which the costs were incurred are immaterial. The sole decisive criterion is that the expenses must have a direct economic connection to the activity which gave rise to taxation in that State, with the result that they are inextricably linked to that activity (e.g. travel and accommodation costs)[1455].

The ECJ then addressed the question at issue in *Scorpio* and held that it was discriminatory to refuse the deductiblity of business expenses upon payment to the non-resident service provider if he had the possibility to obtain a refund of overpaid tax afterwards (i.e. he could request to be taxed on his net income afterwards) whereas resident service providers were taxable on their net income. The Court held that the obligation, even where the non-resident service provider has informed his debtor of the amount of his business expenses directly linked to his activity, to commence a procedure for the subsequent refund of those expenses is liable to impede the provision of services. As commencing such a procedure involves additional administrative and economic burdens, and to the extent that the procedure is inevitably necessary for the provider of services, the German tax legislation was therefore discriminatory[1456].

[1454] C-290/04, *Scorpio*, § 43-44.
[1455] E.g. C-345/04, *Centro Equestre da Lezíria Grande Lda*, 15 February 2007, § 25.
[1456] C-290/04, *Scorpio*, § 45-47.

e. Bouanich[1457]

Ms Bouanich, a French resident, held shares in a Swedish company. Following a reduction in the share capital of the Swedish company, it repurchased the shares held by Ms Bouanich. A dispute arose on the taxation in Sweden of the payment made to Ms Bouanich on this occasion.

Swedish tax law made a distinction between resident and non-resident shareholders with regard to the taxation of such payments. For resident shareholders, a repurchase of shares was taxed as a capital gain at a rate of 30% and the cost of acquisition of the repurchased shares could be deducted. For non-resident shareholders, the repurchase was treated as a dividend distribution and the cost of acquisition could not be deducted. Dividend tax was deducted at source at the rate of 30%, but that rate was often reduced under a tax treaty. Where the tax had been charged at a higher rate than that which ought to have been charged under such a treaty, there was a right to a refund under Swedish law.

Article 10 of the French/Swedish tax treaty restricted the tax rate on dividends in the source State to 15% of the gross amount of the dividends. According to Article 10(5) of the treaty, ‘dividend’ meant, *inter alia*, income from shares and income which, in the distributing company’s State of residence, was treated in the same way as a dividend. Finally, under Article 13(6) of the treaty, a capital gain such as that at issue in *Bouanich* was taxable only in the seller’s State of residence.

The Swedish tax administration assessed Ms Bouanich at a rate of 15% on the whole of the payment received from the Swedish company. Ms Bouanich argued that the Swedish system was incompatible with the free movement of capital because a share repurchase payment made by a Swedish company to a non-resident shareholder was taxed in the same way as a dividend, without there being a right to deduct the cost of acquisition, while such a payment to a resident shareholder was taxed as a capital gain, with a right to deduct the cost of acquisition.

The ECJ first points out that non-resident shareholders were treated less favourably than resident shareholders because the right to a deduction was reserved solely to the latter[1458]. As to the comparability of the situations, the Court holds that the cost of acquisition is directly linked to the payment made on the occasion of a share repurchase so that, in this regard, residents and non-residents are in a comparable situation[1459]. Even though the ECJ does not refer to *Gerritse* or the subsequent judgments, it is clear that the comparability-analysis in *Bouanich* is based on the same reasoning (i.e. the direct link between the cost and the income renders the situations comparable as regards the deductibility of the cost).

f. Gielen[1460]

Mr Gielen was a German resident who operated a horticulture business both in his home State and in the Netherlands, through a PE situated there. Under the domestic tax legislation in the Netherlands, a tax deduction was granted to self-employed taxpayers (‘the self-employed

[1457] C-265/04, *Margaretha Bouanich v Skatteverket*, *ECR* 2006, I-00923, 19 January 2006.
[1458] C-265/04, *Bouanich*, § 32-33.
[1459] C-265/04, *Bouanich*, § 40.
[1460] C-440/08, *F. Gielen v Staatssecretaris van Financiën*, 18 March 2010.

person's deduction'), as a result of which the taxpayer's taxable business profit was reduced by an amount depending on the amount of profit earned.

The application of the self-employed person's deduction was subject to a number of conditions, including the so-called 'hours test', which meant that the taxpayer had to work at least 1,225 hours for the undertakings from which the business profits were derived. For the purpose of applying the hours test, a resident taxpayer could take account of hours worked in the Netherlands and hours worked abroad. For non-resident taxpayers, account was taken only of hours worked in an establishment in the Netherlands[1461].

In the tax year at issue, Mr Gielen worked more than 1,225 hours for his business in Germany, while he worked less than 1,225 hours for the PE in the Netherlands. The Dutch tax authorities denied him the self-employed person's reduction, on the basis that he did not satisfy the hours test. The question arose whether the distinction between residents and non-residents infringed the freedom of establishment.

As to the comparability of the situations, the Court points out that the basic *Schumacker*-incomparability does not apply since the self-employed person's deduction was not related to the taxpayers' personal capacity but rather to the nature of their activity. That deduction was granted to business operators whose main activity is running their business, which is demonstrated, inter alia, by satisfying the hours test. The Court therefore held that, for the purpose of the national measure at issue, the situation of non-resident self-employed taxpayers was comparable to that of resident self-employed taxpayers. As a result, the distinction between residents and non-residents as regards the taking into account of hours worked in another Member State constituted discrimination[1462].

The Advocate-General, who reached the same conclusion as the Court, elaborated a bit on this point. In order to verify whether the national measure at issue related to personal and family circumstances (and would therefore have to be considered as a *Schumacker*-type case), he considered the objective of that measure. In that respect, the Advocate-General pointed out that the measure was intended to give a tax benefit to taxpayers whose main activity was an activity carried out as a self-employed person. In order to achieve that purpose, it was necessary for the number of hours worked to exceed a certain threshold. Consequently, the hours test was not intended to assess a taxpayer's personal and family circumstances but rather to make sure that the benefit was only granted to taxpayers whose principal activity was a business activity. Requiring the stipulated time to have been worked in the Netherlands did not assist in achieving that aim. Therefore, since the measure related to the nature of the taxed activity rather than the personal and family circumstances of the taxable person, the Advocate-General considered a non-resident self-employed taxpayer to be comparable to a resident self-employed taxpayer (at least with regard to the tax deduction at issue)[1463].

[1461] In order to remove that distinction, non-residents could opt to be made subject to the regime applicable to resident taxpayers. The impact of that option on the discrimination at issue will be discussed in 2.E.I.B.9.3.
[1462] C-440/08, *Gielen*, § 44-48. By Decree No. DGB2010/2574M of 10 June 2010 (*Official Gazette* 10 June 2010), the Dutch Minister of Finance acted upon the Court's decision in *Gielen*. As a result of that Decree, non-residents can now take account of hours worked in the Netherlands and hours worked in another Member State.
[1463] Opinion of Advocate-General Colomer in C-440/08, *Gielen*, 27 October 2009, 37-39.

g. Conclusion

With respect to tax benefits that are not connected to the person of the taxpayer, but to the income earned by that taxpayer (refunds of overpaid wage withholding tax, business expenses, etc.), the Court generally sets aside the basic incomparability of residents and non-residents and considers both categories to be comparable. Unlike the cases discussed in 2.E.I.A.b.1, the cases discussed here do not relate to domestic measure that take account of a taxpayer's ability to pay tax. Instead, the domestic measures at issue in these cases are linked to a specific type of income earned or an activity exercised in the Member State in question. Consequently, the relevant characteristic is not the taxpayer's ability to pay but the fact that the taxpayer earns that type of income in the Member State concerned or carries out that activity there, which is reflected in the Member State in question exercising its taxing jurisdiction as regards the relevant income or activity. As a result, non-residents are comparable to residents with respect to the tax treatment of a certain type of income or activity if the source State exercises its taxing powers as regards both non-residents and residents. This idea will be further discussed in 2.E.I.A.b.7.

3. The taxation of outbound permanent establishments

At first glance, it would seem that the taxation of outbound permanent establishments – i.e. the taxation of resident taxpayers doing business in another Member State through a PE in that other Member State – is the perfect mirror image of the cases discussed in 2.E.I.A.a.1, concerning the taxation of inbound permanent establishments. However, that is not entirely accurate. As mentioned in 2.E.I.A.a.1, in inbound PE-cases, the subject of comparison is a non-resident having a PE in State A, the object of comparison is a resident of State A and the comparative attribute is the taxpayer's (non-)residence in State A. By contrast, in outbound PE-cases, the subject of comparison is a resident of State A having a PE in another Member State B, the object of comparison is a resident of State A doing all of its business in its State of residence A, and the comparative attribute is the cross-border activity. As a result, the analysis carried out by the ECJ in both types of cases is not entirely identical.

a. AMID: comparability is the general rule[1464]

Under Belgian corporate tax law, the total amount of profits is broken down into three categories: profits made in Belgium, profits made abroad for which tax is reduced, and profits made abroad and exempted from tax by virtue of a tax treaty. However, before this breakdown is carried out, all losses incurred during the taxable period, in Belgium and abroad, are successively set off against the total amount of profits in a specified order. More specifically, losses incurred in a country for which the profits are exempted by treaty are set off first against profits exempted by treaty and, if these are insufficient, against profits taxable at a lower rate and then against Belgian profits. Losses incurred in a country for which profits are taxable at a lower rate are set off first against profits taxable at a lower rate and, if these are insufficient, against profits exempted by treaty and then against Belgian profits. Finally, losses incurred in Belgium are set off first against Belgian profits and, if these are insufficient, against profits taxable at a lower rate and then against profits exempted by treaty[1465].

[1464] C-141/99, *AMID*, 14 December 2000. See also L. DE BROE and N. BAMMENS, "The Belgian Velasquez doctrine in non-EU situations: an analysis under Belgian constitutional and treaty law", *Bull. IBFD* 2010, 510-516.

[1465] Article 75 of the Royal Decree implementing the Income Tax Code ("RD/ITC"; at the time of the facts giving rise to the *AMID*-case, the relevant provision was Article 66 RD/ITC).

Moreover, losses incurred during previous taxable periods are to be offset in so far as they have not yet been capable of being offset or have not previously been covered by profits exempted by treaty[1466]. This system is commonly known in Belgian tax law as the 'Velasquez-doctrine'[1467].

The effect of this system is that a Belgian company cannot set off its losses incurred in Belgium during a previous taxable period, if those losses were covered by profits exempted by treaty. This is what happened to AMID, a Belgian company with a PE in Luxembourg. Under the tax treaty between Belgium and Luxembourg, AMID's profits from its Luxembourg PE were exempt from tax in Belgium. In 1981, AMID suffered a loss in Belgium while its Luxembourg PE made a profit. In 1982, AMID made a profit in Belgium. Under Luxembourg tax law, it was impossible for AMID to set off the Belgian loss against the Luxembourg profit. Therefore, AMID wanted to deduct the Belgian loss of 1981 from the Belgian profit of 1982. The Belgian tax administration rejected this deduction on the basis that the Belgian loss should have been set off against the Luxembourg profit of 1981, with the result that it could not be deducted from the Belgian profits of 1982. The ECJ was asked whether the Belgian system fell foul of the freedom of establishment in situations where a Belgian company has a PE in another Member State.

The ECJ compared the situation at issue to the situation where the Belgian company would only have establishments in Belgium. In the latter situation, it would be possible to set off the losses incurred during a previous taxable period. Accordingly, the Belgian legislation resulted in a disadvantage to the detriment of resident companies with a PE in another Member State[1468]. In response, the Belgian government argued that the situations could not be compared because Belgian companies that have concentrated all their operations in Belgium have the whole of their income calculated globally and taxed at the rate applicable in Belgium. In contrast, Belgian companies with a foreign PE are taxed by the PE State in respect of the income attributable to the PE[1469].

[1466] Article 78 RD/ITC (at the time of the facts giving rise to the *AMID*-case, the relevant provision was Article 69 RD/ITC).

[1467] Named after the landmark 'Velasquez'-case, Supreme Court 29 June 1984, *F.J.F.* No. 84/164.

[1468] C-141/99, *AMID*, § 23. The *AMID*-judgment has been criticized on the basis that it misinterpreted the Belgian regime. In particular, it could be said that the Belgian regime did not introduce a difference in treatment. That is to say, in Year 1, AMID incurred a loss in Belgium and a profit in Luxembourg which exceeded the Belgian profits. So, overall, AMID was in a profit-generating position. But the Court made the comparison with a Belgian resident which suffers a loss in Belgium and does not have a foreign PE. So the object of comparison was in a loss-making position. It has therefore been argued that the appropriate comparison would be with a Belgian resident which suffers a loss in its (Belgian) head office and makes a profit in its (Belgian) secondary establishment which exceeds that loss. In that comparison, Belgium treats both situations identically: the head office's losses are set off against the secondary establishment's profits and no loss-carry forward is granted in either case. The only difference is that Belgium has surrendered its taxing rights with respect to the Luxembourg profit in the tax treaty, as a result of which the net result will not be taxed in Belgium in AMID's case while the net result will be taxed in Belgium in the case of the object of comparison (see M. ISENBAERT, *EC law and the sovereignty of the Member States in direct taxation*, Amsterdam, IBFD, 2010, 513-514). However, the purpose of this study is not to consider whether the decisions of the ECJ give a correct interpretation to the domestic law under scrutiny. Rather, the purpose is to identify the principle underlying those decisions. So the question is not whether the Court interprets domestic law correctly, but which principles it applies in testing the compatibility of the law so interpreted with the fundamental freedoms. Additionally, while it is true that the Belgian regime under scrutiny did not formally distinguish between domestic situations and cross-border situations, it is clear that it produced a disadvantage for taxpayers having a PE in Luxembourg, such as AMID.

[1469] The Belgian government had also argued that the disadvantage in the case at hand was counterbalanced by a corresponding advantage in other cases. On this argument, see 2.E.I.B.

The Court dismissed this argument, observing that the differences between both situations referred to by the Belgian government *"cannot in any way explain why the former cannot be treated in the same way as the latter for the purposes of the deduction of losses"*[1470]. According to the Court, a Belgian company which has no establishments outside Belgium and which incurs a loss during a given tax year is comparable for tax purposes to a Belgian company which has a PE in Luxembourg and which incurs a loss in Belgium and makes a profit in Luxembourg during that same tax year. Consequently, as there was no objective difference between the situations, the disadvantage suffered by resident companies with a PE in another Member State constituted discrimination.

In other words, the mere fact that part of the income of a resident taxpayer with a foreign PE is taxable in the PE-State, does not render that taxpayer incomparable to a resident taxpayer who has concentrated all his operations in its State of residence.

The Court thus seems to start from an assumption of comparability: a resident taxpayer with a PE in another Member State is comparable to a resident taxpayer who has concentrated all his operations in the State of residence, unless a valid reason for incomparability is demonstrated. The mere fact that the income that can be attributed to the PE is taxable in the PE-State is not a valid reason. This assumption of comparability is understandable, as assuming the opposite would significantly weaken the freedom of establishment: in that case, any exercise of the freedom of establishment giving rise to a PE in another Member State would, in principle, lead to incomparability, unless the taxpayer is able to demonstrate the comparability. The mere exercise of the Treaty freedom would thus, paradoxically, deprive the taxpayer of his protection under that freedom, unless he is able to demonstrate comparability[1471].

b. Columbus Container Services

The same approach was (albeit implicitly) applied in the horizontal analysis of the *Columbus*-case[1472]. In that case, the ECJ first noted that the German legislation at issue did not make any distinction between residents with a PE in another Member State and residents conducting their business in Germany. As a result, there was no discrimination resulting from a difference in treatment between those two situations[1473].

The Court then verified whether the measure was nevertheless discriminatory because it treated incomparable situations identically. However, the Court found no such discrimination because the situations were not incomparable. The Court pointed out that the situations were not rendered incomparable because of the mere fact that the income was received *"from a*

[1470] C-141/99, *AMID*, § 28.
[1471] Similarly: C-293/06, *Deutsche Shell*, 28 February 2008, in which the Court held it contrary to the freedom of establishment for a Member State, when determining the national basis of assessment, to exclude a currency loss suffered by a company with a registered office in that State upon the repatriation of start-up capital granted to its permanent establishment in another Member State. In reaching that conclusion, the Court implicitly considered a taxpayer with a PE in another Member State to be comparable with a taxpayer who has concentrated all his operation in his State of residence (see, e.g. § 31-32: *"**because it exercised its freedom of establishment** Deutsche Shell suffered financial loss which was not taken into account either [in Germany or in Italy] […] It must be held that the tax system at issue in the main proceedings constitutes an obstacle to the freedom of establishment"* (emphasis added): in other words, the comparison is made between a taxpayer who has exercised his freedom of establishment by setting up a PE in another Member State and a taxpayer who has not done so).
[1472] The *Columbus*-case, and its horizontal and vertical aspects, will be discussed in detail in 2.E.I.A.b.2.9.c and 2.E.I.B.b.2. See also 2.E.I.C, on the equal treatment of incomparable situations.
[1473] C-298/05, *Columbus*, 6 December 2007, § 39-40.

company or partnership established in another Member State, which, in exercising its fiscal sovereignty, makes those profits subject to taxation amounting to less than 30% of the profit actually made"[1474]. In other words, the situations are considered to be comparable, and the mere fact that the PE-State subjects the PE-profits to a low rate of taxation does not alter that assumption.

c. Lidl Belgium[1475]

Lidl Belgium, a limited partnership with its registered office in Germany, had set up a PE in Luxembourg. During the accounting period at issue, the Luxembourg PE incurred a loss. When calculating its revenue for tax purposes in Germany, Lidl Belgium sought to deduct that loss from the amount of its tax base. The German tax administration disallowed the deduction of that loss, on the ground that the corresponding income (i.e. the income relating to the PE) was exempt in Germany by virtue of the provisions of the German/Luxembourg tax treaty. As a result of that refusal, Lidl Belgium was treated less favourably than a German company that carried on all its activities in Germany.

The Court first notes that a provision which allows losses incurred by a PE to be taken into account in calculating the profits and taxable income of the principal company constitutes a tax advantage. That tax advantage was granted to German resident companies with respect to losses incurred by German establishments, but not with respect to losses incurred by a PE situated in another Member State. As a result, the tax situation of a resident company with a PE in another Member State was less favourable than it would be if all its activities were carried on in Germany. By reason of that difference in tax treatment, a German company could be discouraged from carrying on its business through a PE situated in another Member State. Consequently, the Court held that the German regime was restrictive[1476].

In other words, the ECJ implicitly assumes that a resident taxpayer with a PE in another Member State is comparable to a resident taxpayer exercising all his activities in the home State.

> MEUSSEN denies this comparability, and argues that a resident company with a foreign PE is incomparable to a resident company with a domestic PE. With regard to a foreign PE, two tax jurisdictions play a role, which is not the case for a domestic PE. The principle of territoriality explains why the home State cannot be required to take the foreign loss into account: territoriality thus implies symmetry between the taking into account of profits and the taking into account of losses[1477].
>
> I tend to disagree with that position. As argued in 2.E.I.A.a.1.c, 2.E.I.A.b.4 and 2.F.III, the principle of territoriality implies that distinguishing between residents and non-residents may be justified because of their different scope of tax liability. That argument is irrelevant in the context of *Lidl*, where the comparison is made between two residents, who have the same scope of tax liability. The case law discussed here, starting with *AMID*, clarifies that the basic comparability of two residents is not altered by the fact that the income attributable to the PE is exclusively taxable in the PE State.

1474 C-298/05, *Columbus*, § 42.
1475 C-414/06, *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn*, 15 May 2008.
1476 C-414/06, *Lidl Belgium*, § 18-26.
1477 G. MEUSSEN, "Cross-border loss compensation and permanent establishments: Lidl Belgium and Deutsche Shell", *European Taxation* 2008, 234.

> Of course, the fact that the PE-income is exempt in the taxpayer's home State is relevant when determining whether the PE-losses should be taken into account in that State. However, that aspect does not concern the comparability of the situations, but the justification of the discrimination (see hereafter).

Ultimately, the Court considered the German measure to be justified on the basis of the need to preserve a balanced allocation of taxing powers taken together with the need to prevent the risk that losses may be taken into account twice[1478]. In particular, the profits attributable to the PE were exempt under the provisions of the German/Luxembourg tax treaty. Since the refusal to take account of the losses connected to the PE thus safeguards the symmetry between the right to tax profits and the right to deduct losses, the Court holds that that refusal can be justified by the need to prevent a balanced allocation of taxing powers[1479]. As to the second justification ground, the Court notes that there is clearly a risk in the present case that the same losses would be used twice: first in Germany and then in Luxembourg when the PE generates a profit in a subsequent tax year[1480].

Lidl Belgium argued that the measure was not proportionate to those objectives because there was a less restrictive measure available, namely allowing the losses to be taken into account in Germany, subject to the condition that the subsequent profits of the PE are taken into account in the taxable base in Germany to the extent of the losses previously offset. The Court dismissed that argument on the basis that it was possible to take the losses into account in Luxembourg when the PE generates a profit in a subsequent tax year.

That distinguishes *Lidl Belgium* from *Marks & Spencer*. In the latter case, attention was drawn to the situation where the non-resident subsidiary had exhausted the possibilities for having its losses taken into account in its Member State of establishment for the year at issue and for preceding years, and there was no possibility in that State for the losses to be carried forward. In such a situation, the Court considered the refusal by the parent company's Member State of establishment to take account of those losses to be disproportionate[1481]. In *Lidl Belgium*, however, there was a possibility to have the PE-losses taken into account in the PE-State, with the result that the refusal by Germany to take those losses into account was not disproportionate[1482].

d. Krankenheim[1483]

The issue in *Krankenheim* was somewhat similar to that in *Lidl Belgium*. Krankenheim was a German company with a PE in Austria. Under **German** law at the relevant time, resident taxpayers could request that losses suffered by a foreign PE were deducted from their worldwide income, if certain conditions were met. Where, in one of the following taxation periods, the foreign PE made a profit, the deducted amount was subsequently taken into account again (i.e. added back) in calculating the taxpayer's income, up to the amount of the profits made by the PE. Under **Austrian** law at the relevant time, losses incurred by Austrian

[1478] C-414/06, *Lidl Belgium*, § 30-53.
[1479] C-414/06, *Lidl Belgium*, § 33 and 52.
[1480] C-414/06, *Lidl Belgium*, § 36.
[1481] C-446/03, *Marks & Spencer*, § 55-56.
[1482] C-414/06, *Lidl Belgium*, § 45-51.
[1483] C-157/07, *Finanzamt für Körperschaften III in Berlin v Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH*, 23 October 2008.

PEs of non-resident companies could only be carried forward where the undertaking concerned did not make any profit overall, i.e. as regards its worldwide income.

Applying the German legislation, Krankenheim deducted from its income the losses incurred by its Austrian PE between 1982 and 1991. Between 1992 and 1994, however, the PE made a profit. The German tax authorities therefore added the deduction back to Krankenheim's income for those periods, up to the amount of the profits made by the PE. On the other hand, Krankenheim was unable to carry over the losses suffered between 1982 and 1991 in Austria because its overall worldwide income in those periods was positive.

The question thus arose whether the German legislation fell foul of the freedom of establishment. Referring to *Lidl Belgium*, the ECJ first observed that provisions which allow losses incurred by a PE to be taken into account in calculating the profits and taxable income of the principal company constitute a tax advantage. Granting or not granting such an advantage for a PE situated in another Member State must therefore be regarded as a factor likely to affect the freedom of establishment. Unlike the legislation at issue in *Lidl Belgium*, the German measure at issue provided that losses made by the foreign PE were taken into account in the results of the German head office.

Accordingly, the German tax authorities had granted a tax advantage to the resident company with a PE situated in Austria, in the same way as if that PE had been situated in Germany. However, by subsequently proceeding to reintegrate those losses into the basis of assessment of the principal company when the latter had made profits, the benefit of that tax advantage was withdrawn. The Court continues: *"Even though that reintegration operated only up to the amount of the profits made by that permanent establishment, the fact remains that, to that extent, the German legislation thus subjected resident companies with permanent establishments in Austria to* ***less favourable treatment than that enjoyed by resident companies with permanent establishments situated in Germany****. In those circumstances, the tax situation of a company which has its registered office in Germany and has a permanent establishment in Austria is* ***less favourable than it would be if the latter were to be established in Germany****. By reason of that difference in tax treatment, a German company could be discouraged from carrying on its business through a permanent establishment situated in Austria"*[1484]. Accordingly, the German measure restricted the freedom of establishment[1485].

So once again, the ECJ implicitly assumes that resident taxpayers with a PE in another Member State are comparable to resident taxpayers exercising all their activities in their home State.

It might be interesting to highlight the contrast between the cases discussed here and those discussed in 2.E.I.A.a.1, concerning inbound permanent establishments. In *AMID*-type cases, involving outbound PEs, the starting point is comparability and the mere fact that the taxing power in respect of the PE-income is allocated to the PE-State does not alter this comparability. In contrast, the starting point in the cases discussed in 2.E.I.A.a.1 (*Avoir fiscal*, *Futura*, etc.) was incomparability. Non-residents with a PE in a certain Member State are not comparable to residents of that Member State, because it is assumed that the majority of their income is centered in their State of residence. In other words: the starting point in inbound PE-cases is incomparability, because of the difference in ability to pay. The starting point in

[1484] C-157/07, *Krankenheim*, § 27-38 (emphasis added).
[1485] Ultimately, however, the ECJ considered the measure to be justified (see 2.F.III).

outbound PE-cases is comparability, **because it is assumed that the ability to pay is identical for both taxpayers** (both taxpayers are residents whose income is assumed to be centered in their State of residence).

4. The tax treatment of resident parent companies with non-resident subsidiaries: discrimination on the basis of the subsidiary's seat

a. ICI[1486]

The taxpayer, ICI, was a U.K. resident company that formed a consortium with another U.K. resident company, through which they beneficially owned 49% and 51%, respectively, of Holdings, a U.K. resident company. The sole business of Holdings was to hold shares in 23 trading companies which were its subsidiaries and which operated in a number of different countries. Of those 23 subsidiaries, 4 were resident in the U.K., 6 in other Member States and 13 in non-member countries.

One of the 4 U.K. resident subsidiaries, CAH, incurred losses on its U.K. trade in three subsequent accounting periods. ICI requested the U.K. tax administration to set off 49% of CAH's losses (the proportion corresponding to ICI's shareholding in Holdings) against its chargeable profits for the corresponding periods by way of tax relief.

Under U.K. tax law at the material time, the group relief system functioned as follows. Relief from corporation tax for trading losses could be surrendered by a company ('the surrendering company') which was a member of a group of companies to another company ('the claimant company') of the same group. Group relief was also available where either the surrendering company or the claimant company was a member of a consortium and the other was a trading company which was a 90% subsidiary of a holding owned by the consortium. A 'holding company' was defined as a company the business of which consisted wholly or mainly in the holding of shares of trading companies which were its 90% subsidiaries. A 'company' referred only to bodies corporate resident in the U.K.

The U.K. tax administration refused ICI's application for tax relief on the ground that Holdings was not a 'holding company' within the meaning of U.K. tax law. Even though Holdings' sole business was to hold shares of trading companies which were its 90% subsidiaries, the majority of its subsidiaries (19 out of 23) were not bodies corporate resident in the U.K. Therefore Holdings' main business was not recognised as that of a holding company within the meaning of U.K. tax law.

According to ICI, the U.K. regime was discriminatory because tax relief for losses incurred by a resident company, which was a subsidiary of a resident holding company, was granted to a member of a consortium where all (or most of) the subsidiaries controlled by the holding company were resident, whereas it was refused where the holding company controlled mainly subsidiaries resident in other Member States.

The ECJ first noted that the U.K. regime distinguished between consortium companies established in the U.K. on the basis of the subsidiaries' seat. In particular, consortium relief was available only to companies controlling, wholly or mainly, subsidiaries whose seats were

[1486] C-264/96, *Imperial Chemical Industries plc (ICI) v Colmer*, 16 July 1998.

in the U.K.[1487] In defence of its regime, the U.K. government argued that *"for the purposes of direct taxation, the respective situations of resident and non-resident companies are not, as a general rule, comparable"*[1488]. Unfortunately, the U.K. government does not clarify why this general incomparability of residents and non-residents would be relevant in the present case. Instead, it brings forward two justification grounds (the risk of tax avoidance and the reduction in tax revenue), both of which are – unsurprisingly – rejected by the Court[1489].

The comparison to be made in *ICI* was between two categories of resident taxpayers: on the one hand, a company belonging to a consortium through which it controls a holding company where the majority of the holding's subsidiaries are resident companies and, on the other hand, a company belonging to a consortium through which it controls a holding company that does not meet this requirement. The mere fact that residents and non-residents are, in principle, incomparable, does not explain why the subject and object of comparison in *ICI* would be incomparable. Obviously, it is possible that the place of residence of the holdings' subsidiaries has some effect on this comparison, but the U.K. government does not substantiate its claim that they are, in fact, incomparable. This may explain why the ECJ does not address the comparability-test, but instead implicitly assumes that subject and object of comparison are comparable. As the justification-grounds were not convincing, the Court ultimately decides that the U.K. regime infringed the freedom of establishment.

The remainder of this section is concerned with the question whether a resident company with a non-resident subsidiary and a resident company with a resident subsidiary are comparable. As a general assumption, it could be argued that two types of resident taxpayers are comparable, unless there is a reason why they are incomparable. An analysis of the relevant case law in this regard reveals whether the ECJ has taken this approach.

b. X AB and Y AB[1490]

This case concerns the Swedish regime on intra-group transfers, which was already discussed in Part II, 2.F.I.C.d and 2.F.III.B.c. Under that regime, if a Swedish company (X AB) owned more than 90% of the shares in another Swedish company (Y AB), transfers between those companies were treated as deductible expenses for the transferring company and as taxable income for the transferee. In order for the intra-group transfer regime to apply, both the transferring company and the transferee had to be Swedish residents. Moreover, the parent company of the group, as well as any intermediary company (e.g., where the parent company made a transfer to a sub-subsidiary), had to be resident in Sweden as well.

The issue to be decided concerned the situation where the participation in Y AB was not held exclusively by X AB but also by a subsidiary of X AB. In that respect, three possible cases could be distinguished.

In the first case ('type A transfers'), the shares in Y AB were held by X AB and another Swedish 100% subsidiary of X AB. In that case, the statute provided that the intra-group regime could be applied (see supra).

[1487] C-264/96, *ICI*, § 23.
[1488] C-264/96, *ICI*, § 25.
[1489] C-264/96, *ICI*, § 25-28.
[1490] C-200/98, *X AB and Y AB v Riksskatteverket*, 18 November 1999.

In the second case ('type B transfers'), 85% of the shares in Y AB was held by X AB while the remaining 15% was held by Z BV, a Dutch 100% subsidiary of X AB. The tax treaty between Sweden and the Netherlands contained a non-discrimination clause analogous to Art. 24 OECD MC. Under the Swedish legislation, the intra-group regime did not apply to that situation. However, the Swedish Supreme Administrative Court had decided that it would be contrary to the ownership non-discrimination provision of the applicable tax treaty if the benefit would be denied. In particular, a Swedish company with a non-resident parent would then be discriminated against as compared to a Swedish company with a resident parent (see Part II, 2.F.III.B.c). For that reason, the regime was also applied in cases where the Swedish parent company held the shares in the Swedish subsidiary together with one or more wholly-owned subsidiaries established in a State with which Sweden has concluded a tax treaty containing an ownership non-discrimination clause.

In the third case ('type C transfers'), 70% of the shares in Y AB was held by X AB, while 15% was held by Z BV, a Dutch 100% subsidiary of X AB and 15% was held by Z GmbH, a German 100% subsidiary of X AB. Both the Swedish treaty with Germany and that with the Netherlands contain a non-discrimination clause analogous to Art. 24 OECD MC. In this case, the intra-group regime could not be applied. The Swedish Supreme Administrative Court had held that, in order to apply that regime, it was necessary to apply the ownership non-discrimination clauses of two tax treaties cumulatively (i.e. the clauses in the German / Swedish treaty and the Dutch/Swedish treaty). That was held to be impossible because the provisions of those treaties were intended to be applied only to residents of the contracting States and not to those of third States (see Part II, 2.F.I.C.d).

The question thus arose whether the freedom of establishment precluded Sweden from applying granting tax benefits to type A transfers and type B transfers while refusing those benefits to type C transfers.

The ECJ held that, by refusing the tax benefits to type C transfers, the Swedish legislation at issue gave rise to a difference in treatment on the basis of the seat of a resident company's subsidiary. As a result, Swedish resident companies could be deterred from exercising their freedom of establishment by forming subsidiaries in other Member States. In the absence of justification, that difference in treatment therefore infringed the freedom of establishment. According the ECJ, *"it does not make any difference in this regard that the case-law of the [Swedish Supreme Administrative Court] allows type B transfers to be given the same treatment accorded to type A transfers"*[1491].

It is not immediately clear what comparison the ECJ makes: does the Court compare the subject of comparison (type C transfers) to type A transfers or to type B transfers? Given the brevity of the Court's reasoning and the statement that the Swedish rule at issue *"does not allow Swedish companies which have used their right to free establishment to form subsidiaries* ***in other Member States*** *to receive certain tax concessions upon a type C intra-group transfer"*[1492], it seems that the comparison was made with type A transfers.

Clearly, there was no real reason to make a comparison with type B transfers: as soon as it is established that there is discrimination as compared to the domestic situation, the analysis is complete. It is not necessary to verify whether there also is discrimination as compared to another cross-border situation. Some support for that conclusion can be found in the statement

[1491] C-200/98, *X AB and Y AB v Riksskatteverket*, § 27-28.
[1492] C-200/98, *X AB and Y AB v Riksskatteverket*, § 27.

quoted above, that *"it does not make any difference in this regard that the case-law of the [Swedish Supreme Administrative Court] allows type B transfers to be given the same treatment accorded to type A transfers"*. That statement seems to imply that it is sufficient to establish that type C transfers were discriminated against as compared to type A transfers. The treatment of type B transfers is entirely irrelevant[1493].

That being said, the Court does not give any reasons **why** it considers resident companies with non-resident subsidiaries to be comparable to resident companies with resident subsidiaries. This seems to confirm the idea that the ECJ generally considers two residents to be comparable, unless there are valid reasons for incomparability.

Finally, it is interesting to note that the ECJ considers the Swedish regime to constitute discrimination on the basis of the residence of a Swedish company's **subsidiary**, while the discrimination under Art. 24 OECD MC was on the basis of the residence of a Swedish company's **parent company**. The reason is obvious: Art. 24 OECD MC is narrower in that it only prohibits discrimination on the basis of foreign ownership, but not on the basis of a resident owning a non-resident subsidiary. In contrast, the freedom of establishment covers both types of discrimination.

c. Bosal[1494]

Facts and decision

Bosal was a holding company established in the Netherlands with several subsidiaries in other Member States. Bosal incurred costs in relation to the financing of its holdings in those subsidiaries, and wanted to deduct those costs from its own profits.

Dutch tax law at the material time provided that, in determining the taxable profit of a taxpayer, no account was taken of gains acquired from a holding or of the costs relating to a holding, unless such costs were indirectly instrumental in making profits taxable in the Netherlands. On the basis of this provision, the Dutch tax authorities denied Bosal's claim to deduct the costs relating to its subsidiaries. The ECJ was asked whether the Dutch legislation fell foul of the freedom of establishment.

[1493] The Advocate-General took the same approach by pointing out that the relevant question was whether the freedom of establishment precludes *"the rules contained in the Swedish legislation in principle, that is to say irrespective of whether or not there is a double-taxation agreement. It should therefore be considered whether [the freedom of establishment] preclude[s] legislation of a Member State under which a parent company cannot benefit from fiscal effects if the company to which a transfer is made is owned by companies belonging to the same group but established in other Member States"* (Opinion of Advocate-General Saggio in C-200/98, *X AB and Y AB v Riksskatteverket*, 3 June 1999, § 19). No comparison is made between type B transfers and type C transfers. As soon as cross-border situations (i.e. type C transfers) are discriminated against as compared to domestic situations (i.e. type A transfers), there is an infringement of the freedom of establishment. The fact that the disadvantage is removed in **some** cross-border situations, namely where a tax treaty non-discrimination clause applies (i.e. type B transfers) does not alter that conclusion, because the effects of the freedom of establishment should not be made subject to the existence of a tax treaty to begin with. The Advocate-General therefore holds that the fact that the Swedish regime applies in cases where a tax treaty has been concluded *"is irrelevant, since the scope of [the freedom of establishment] cannot depend on the existence of such agreements; indeed, precisely on the subject of double-taxation agreements, the Court has held that 'the rights conferred by [the freedom of establishment] are unconditional and a Member State cannot make respect for them subject to the contents of an agreement concluded with another Member State. In particular, that article does not permit those rights to be made subject to a condition of reciprocity imposed for the purpose of obtaining corresponding advantages in other Member States'."* (§ 24 of the Opinion, referring to *Avoir fiscal*).

[1494] C-168/01, *Bosal Holding BV v Staatssecretaris van Financiën*, 18 September 2003.

The Court first noted that the deductibility of costs under Dutch tax law depended solely on the question whether those costs were 'indirectly instrumental' in the making of profits taxable in the Netherlands. There was no requirement that the subsidiaries were established in the Netherlands. A parent company established in the Netherlands would thus have the right to deduct from its taxable profit in the Netherlands costs in connection with the financing of its holdings in subsidiaries themselves established in the Netherlands or in subsidiaries established in other Member States but having a PE in the Netherlands[1495]. Nevertheless, the requirement that the losses had to be indirectly instrumental in making profits which are taxable in the Netherlands constitutes a hindrance to the establishment of subsidiaries in other Member States. Because of that limitation, a parent company might be dissuaded from carrying on its activities through the intermediary of a subsidiary established in another Member State since such a subsidiary normally does not generate profits that are taxable in the Netherlands[1496].

The Dutch government argued that subsidiaries which make taxable profits in the Netherlands and those which do not are not comparable. The government relied on the principle of territoriality, as it was recognised by the ECJ in *Futura*, to argue that there was an objective difference between subsidiaries according to whether or not they carry on business abroad. In the first case, it is not the whole of the profits made by the group of companies concerned which is made subject to the Dutch tax, whereas that is the case with the second hypothesis. Accordingly, the costs in connection with activities abroad, including financing costs and costs in relation to holdings, should be set off against the profits generated by those activities and the deduction of those costs is linked solely to the profits made outside the Netherlands. Given the difference in situation, the Dutch government argued that the difference in treatment was not discriminatory[1497].

The Court dismisses this argument. First, it noted that the territoriality principle in *Futura* concerned the taxation of a single company which carried on business in its Member State of establishment and in another Member State where it had a PE. In the present case, however, this argument is irrelevant according to the Court. The difference in tax treatment in *Bosal* concerns resident parent companies according to whether or not they have subsidiaries making profits taxable in the Netherlands. As regards their tax situation in relation to the profits of their subsidiaries, the Court notes that those profits are not taxable in the hands of the parent companies, whether the profits come from subsidiaries taxable in the Netherlands or from other subsidiaries.

The Court then refers to its case law concerning the different tax treatment of subsidiaries depending on the seat of their parent companies (see 2.E.I.A.b.5). In that case law, the Court has held that the different situation (i.e. the difference in the tax treatment) of parent companies depending on whether or not they were resident could not justify denial of a tax advantage to resident subsidiaries of parent companies having their seat in another Member State where that advantage was available to resident subsidiaries of resident parent companies, since all those subsidiaries were liable to the same tax regime on their profits irrespective of the place of residence of their parent companies[1498].

[1495] C-168/01, *Bosal*, § 13.
[1496] C-168/01, *Bosal*, § 27.
[1497] C-168/01, *Bosal*, § 18.
[1498] C-168/01, *Bosal*, § 37-40, referring to Joined Cases C-397/98 and C-410/98, *Metallgesellschaft*, § 60.

Commentary

As mentioned in 2.E.I.A.a.1, there may be some confusion as to whether the territoriality principle concerns the comparability-test or the justification-test[1499]. In *Bosal*, the Court does not address this issue. It simply points out that the territoriality argument is irrelevant in the case at hand. And that is correct, irrespective of whether territoriality is a matter of comparability or justification. Indeed, *Bosal* did not concern a comparison of residents and non-residents, but a comparison between resident companies according to whether or not they have subsidiaries making profits in the Netherlands[1500]. In that respect, the different scope of tax liability of residents and non-residents is not immediately relevant.

The obvious counter-argument would be that the category of 'subsidiaries making profits in the Netherlands' will generally include more resident companies, while 'subsidiaries not making profits in the Netherlands' will generally include more non-resident companies. That is what the Court acknowledges in *Bosal* by pointing out that the limitation provided for by the legislation at issue might dissuade resident parent companies from establishing non-resident subsidiaries since such subsidiaries will generally not generate profits that are taxable in the Netherlands (see supra). Accordingly, the two categories of subsidiaries at issue are actually resident and non-resident subsidiaries, and they should in principle be considered incomparable since residents and non-residents are generally incomparable.

Yet, that does not affect the observation made above. Indeed, the comparison was not between those two types of subsidiaries, but between two resident companies according to the type of subsidiaries they have. As the parent and the subsidiary are two distinct legal persons, the differences at the level of the subsidiaries (i.e. incomparability of resident and non-resident subsidiaries) does not affect the resident parent companies. The Court therefore concludes as follows: *"As regards the tax situation of [the resident parent companies] in relation of the profits of their subsidiaries, […] it must be noted that those profits are not taxable in the hands of those companies, whether the profits come from subsidiaries taxable in the Netherlands or from other subsidiaries"*[1501].

Consequently, even though there may be an incomparability at the level of the subsidiaries, the resident parent companies are comparable. To illustrate this comparability, the Court refers to its case law concerning the different tax treatment of a subsidiary depending on whether its parent company was a resident taxpayer or not (see 2.E.I.A.b.5). In those cases, there was an incomparability at the level of the parent companies (because the parent company of the subject of comparison was a non-resident, while the parent company of the object of comparison was a resident), but this did not affect the comparability of the subsidiaries: both were residents and therefore, in principle, comparable.

[1499] See also D. WEBER, "The Bosal Holding case: analysis and critique", *EC Tax Review* 2003, 4, 228; J. ENGLISCH, "The European Treaties' implications for direct taxes", *Intertax* 2005, 330.

[1500] See also C-39/04, *Laboratoires Fournier*, 10 March 2005, which dealt with French legislation that restricted the benefit of a tax credit for research to research carried out in France. Referring to *Futura*, the French government argued that the difference in treatment was a direct result of the territoriality-principle. The ECJ disagreed, pointing out that *Futura* concerned the comparison of a resident taxpayer and a non-resident taxpayer. In contrast, *Laboratoires Fournier* concerned the comparison of two residents, one of whom carried out research in France, while the other carried out research in another Member State. Accordingly, the territoriality-argument as it was used in *Futura*, was irrelevant here (see C-39/04, *Laboratoires Fournier*, § 17-18).

[1501] C-168/01, *Bosal*, § 39.

Once again, it should be noted that the setting up of a subsidiary in another Member States is an aspect of the freedom of establishment, as is the setting up of a PE in another Member State. Assuming that a resident company with a non-resident subsidiary is, in principle, incomparable to a resident company with a resident subsidiary would imply that the mere exercise of a Treaty freedom renders a taxpayer incomparable to a taxpayer who has not exercised this freedom. This would significantly decrease the freedoms' effectiveness in tax matters (see supra, 2.E.I.A.b.3.a).

Of course, this does not mean that two residents – one of which has a subsidiary in another Member State – are always comparable. It is up to the Member State that introduces a distinction between these two categories to demonstrate why they are incomparable by referring to a difference between them which is relevant from the perspective of the domestic measure at issue. For instance, the Member State may argue that resident taxpayers in receipt of domestic income and resident taxpayers in receipt of foreign income are incomparable[1502]. If the Member State succeeds in reversing the burden of proof, it is up to the taxpayer to demonstrate that the situations are nevertheless comparable[1503]. Moreover, even in the event that the situations are comparable, a Member State may still justify the discrimination.

In *Bosal*, the Dutch government could therefore have argued that the situations were incomparable, precisely because the non-resident subsidiary's profits were exempt in the Netherlands. As parent companies with non-resident subsidiaries are not taxable in respect of profits earned by those subsidiaries, they are not comparable to parent companies with resident subsidiaries as regards the deduction of costs relating to those subsidiaries[1504]. Of course, this is also an aspect of the principle of territoriality (i.e. the different scope of tax liability of resident and non-resident subsidiaries explains why the former category's profits are subject to tax while the latter's are exempt), but not in the sense as it was used in *Futura*. As discussed earlier, *Futura* concerned the comparison of a resident taxpayer to a non-resident taxpayer, while *Bosal* concerned the comparison of two resident taxpayers. This distinction is crucial: while the starting point in the former situation is incomparability, the opposite is true in the latter situation. However, it is possible that two categories of residents are nevertheless incomparable, i.e. if the incomparability at the level of the subsidiaries is a relevant characteristic at the level of the parent companies. In particular, **with respect to the possibility for parent companies to offset losses relating to their subsidiaries**, the taxability of those subsidiaries' profits may affect their comparability.

Accordingly, it could be argued that, with respect to measures relating to such losses, parent companies with non-resident subsidiaries cannot be compared to parent companies with resident subsidiaries because the profits of non-resident subsidiaries are exempt in the parent company's State of establishment[1505]. It is therefore unfortunate that the Dutch government

---

[1502] E.g. C-315/02, *Lenz*, § 28: *"[The Austrian government argues] that the Austrian authorities collect the tax on the profits which companies established in Austria distribute to their shareholders partly from the companies and partly from the shareholders. In relation to companies established outside their territory, the Austrian authorities are not in a position to levy the tax on revenue from companies in the same way."*

[1503] See, for instance, the *Lenz/Manninen* comparability, discussed in 2.E.I.A.b.6.b: even though resident taxpayers in receipt of domestic dividends and resident taxpayers in receipt of foreign dividends are, in principle, incomparable, the taxpayer succeeded in demonstrating their comparability. Because both dividend streams were susceptible to double taxation and the national rule at issue was designed to mitigate the effects of this double taxation, the situations were held to be comparable.

[1504] See also the Opinion of Advocate-General Geelhoed in C-374/04, *ACT*, § 62-63.

[1505] See also infra, 2.E.I.A.b.6.c, on the tax treatment of outbound dividends. In C-374/04, *ACT*, § 68 for instance, the Court held that there is comparability where a Member State *"unilaterally or by a convention,* relied on *Futura* when making this argument. Perhaps the Court might have responded differently had the comparison been focussed on the different tax treatment at the level of the subsidiaries' profits. The subsequent *Marks & Spencer* offers some guidance in this respect.

d. Marks & Spencer[1506]

At issue in *Marks & Spencer* was the U.K. group relief regime, as it was amended after *ICI* (see supra). The taxpayer was a U.K. resident company with several subsidiaries in the U.K. and in other Member States. In 2001, the taxpayer's French subsidiary was sold to third parties, while the other subsidiaries established in Belgium and Germany had ceased trading. The taxpayer claimed group tax relief in the U.K. in respect of losses incurred by its subsidiaries in France, Belgium and Germany for accounting years 1998 to 2001.

Due to an amendment following the ECJ's judgment in *ICI*, the U.K. group relief was no longer restricted to U.K. resident companies. Instead, the regime was made applicable to profits and losses within the scope of U.K. tax law. As a result of that amendment, losses made by a U.K. branch of a non-resident company could be surrendered to another group company and offset against its U.K. taxable profits, and losses made by a group company established in the U.K. could be surrendered to a U.K. branch of non-resident company and offset against its profits in the U.K.

Each of the taxpayer's non-resident subsidiaries in *Marks & Spencer* had operated in the Member State in which it had its registered office. The subsidiaries had no PE in the U.K. and had never traded there. Consequently, the U.K. tax administration rejected the taxpayer's claim for group relief on the ground that relief could only be granted for losses recorded in the U.K. The question arose whether the U.K. regime was contrary to the freedom of establishment because resident parent companies were precluded from deducting from their taxable profits losses incurred in another Member State by a subsidiary established in that Member State although they could deduct losses incurred by a resident subsidiary.

The ECJ first observed that there was a disadvantage, because the relief was excluded in respect of losses incurred by a subsidiary established in another Member State which did not conduct any trading activities in the parent company's Member State[1507].

The Court then seemingly turns to the justification-test, without assessing the comparability of the situations. As noted in 2.D.V.B.c, however, this is deceptive. In particular, the U.K. government had argued that the situation of resident subsidiaries and non-resident subsidiaries was not comparable in the context of a group relief system such as the U.K. regime. In accordance with the principle of territoriality, the Member State in which the parent company is established has no tax jurisdiction over non-resident subsidiaries. Tax competence as regards such subsidiaries belongs in principle to the States on whose territory they are established.

---

imposes a charge to income tax not only on resident shareholders but also on non-resident shareholders in respect of dividends which they receive from a resident company." Accordingly, the comparability results from the imposition of the same tax not only on dividends received by residents but also on dividends received by non-residents. *A contrario*, it could be held that where a Member State exempts one type of income but taxes another type of income, the situations are incomparable.

[1506] C-446/03, *Marks & Spencer plc v David Halsey*, 13 December 2005.

[1507] C-446/03, *Marks & Spencer*, § 32-33.

This is similar to the argument brought forward by the Dutch government in *Bosal* (see supra), but here the comparison is shifted to the level of the parent companies. Unlike the Dutch government in *Bosal*, the U.K. government in *Marks & Spencer* does not merely point out that resident and non-resident subsidiaries are incomparable. Instead, the U.K. government relies on this incomparability at the subsidiary-level to argue that the parents are also incomparable: *"the Member State in which the parent company is established has no tax jurisdiction over non-resident subsidiaries. As regards the latter, tax competence belongs in principle, in accordance with the usual allocation of competence in such matters, to the States on whose territory they are established and carry out commercial activities"*[1508].

Accordingly, the comparison is no longer between resident subsidiaries and non-resident subsidiaries, but between parent companies with resident subsidiaries and parent companies with non-resident subsidiaries. This might explain why the ECJ does not simply point out that the government's argument in *Marks & Spencer* was "irrelevant" (see supra, *Bosal*). Instead, the Court notes that residence may be a valid distinguishing factor in tax law. However, that is not always the case. Referring to *Avoir fiscal*, the Court reiterates that allowing Member States to apply a different treatment to companies solely by reason of the fact that their registered office is situated in another Member State would deprive the freedom of establishment of all meaning. The Court thus holds that, in each specific situation, it is necessary to consider whether the fact that a tax advantage is available solely to resident taxpayers is based on relevant objective elements[1509].

Applied to the facts of *Marks & Spencer*, the Court accepts that, *"by taxing resident companies on their worldwide profits and non-resident companies solely on the profits from their activities in that State, the parent company's Member State is acting in accordance with the principle of territoriality enshrined in international tax law and recognised by Community law. However, the fact that it does not tax the profits of the non-resident subsidiaries of a parent company established on its territory does not in itself justify restricting group relief to losses incurred by resident companies. In order to ascertain whether such a restriction is justified, it is necessary to consider what the consequences would be if an advantage such as that at issue in the main proceedings were to be extended unconditionally"*[1510].

In other words, the Court does not accept the U.K. government's argument that the principle of territoriality means that there is an incomparability at the level of the resident parent companies. Instead, the Court considers territoriality as an aspect of the justification-test (see also 2.F.III). In order to verify whether it is justified to restrict the U.K. regime to resident companies with resident subsidiaries, the Court considers what the consequences would be if the advantage at issue were extended to resident companies with non-resident subsidiaries. That is an aspect of the justification-test: in order to verify whether the discrimination is justified, the Court examines what would happen if the legislation were not discriminatory. The reason why the U.K. has reserved the group relief advantage to resident companies with resident subsidiaries, is that it felt that an extension towards resident companies with non-resident subsidiaries would entail several risks. If the Court considers those risks convincing, then the discrimination is justified[1511].

[1508] C-446/03, *Marks & Spencer*, § 36.
[1509] C-446/03, *Marks & Spencer*, § 37-38.
[1510] C-446/03, *Marks & Spencer*, § 39-41.
[1511] See C-446/03, *Marks & Spencer*, § 40-51: the U.K. government relied on three factors, namely the need to preserve balanced allocation of taxing powers between the Member States, the danger that losses may be used

Put briefly, the Court does not accept that resident companies with non-resident subsidiaries are incomparable to resident companies with resident subsidiaries. The territoriality-argument does not alter that conclusion, not even when it is specifically transposed to the parent company-level. Accordingly, the Court's conclusion in *Bosal* with respect to comparability still holds: the incomparability at the level of the subsidiaries does not affect the comparability at the level of the parent companies, since the parent and subsidiary are separate legal persons. The starting point in *Marks & Spencer*-type situations is comparability because the comparison is between two resident taxpayers. The incomparability at the subsidiary-level in itself does not affect this comparability.

e. Keller[1512] *and Rewe*[1513]*: Marks & Spencer confirmed*

Both *Keller* and *Rewe* concerned the differentiated tax treatment in Germany of resident companies depending on whether their subsidiaries were established in Germany. Both confirmed the approach taken in *Marks & Spencer*, as it was set out above.

Keller

Keller Holding, a German resident company, was the sole shareholder of Keller Grundbau, also a German resident company. Keller Grundbau in turn was the sole shareholder of Keller Wien, an Austrian resident company. Keller Wien distributed dividends to Keller Grundbau. Under the tax treaty between Germany and Austria, these dividends were exempt in Germany. Keller Grundbau subsequently redistributed the dividends to Keller Holding.

Under German domestic tax law, a resident company could redistribute within its group dividends received which were exempt under a tax treaty, without those dividends being included in the basis of assessment of the ultimate recipient company. As a result, the dividends redistributed by Keller Grundbau to Keller Holding were not included in Keller Holding's basis of assessment.

Costs related to tax-free profits could not be deducted when determining the basis of assessment. Consequently, financing costs relating to a holding in a non-resident company (such as Keller Wien) could not be deducted by the ultimate recipient of the dividends (such as Keller Holding) if those dividends were not included in the latter's basis of assessment. In contrast, dividends received in a purely domestic situation were included in the basis of assessment, but the tax already paid at the level of the distributing company was set off against the tax payable by the company receiving the dividends. As a result, even though the dividends were included in the basis of assessment of the company receiving them, that company was ultimately exempt from tax on those dividends. Nevertheless, because the dividends had been included in the basis of assessment, the financing cost relating to those dividends could be deducted. Keller Holding argued that the German regime infringed the freedom of establishment because it introduced a difference in treatment between resident companies on the basis of the seat of their indirect subsidiary.

---

twice and the risk of tax avoidance. The Court found these factors to be convincing and therefore held the measure to be justified.

[1512] C-471/04, *Finanzamt Offenbach am Main-Land v Keller Holding GmbH*, 23 February 2006.

[1513] C-347/04, *Rewe Zentralfinanz v Finanzamt Köln-Mitte*, 29 March 2007.

The ECJ first noted that the tax position of a resident company with an indirect subsidiary in Austria was less favourable than that of a resident company with an indirect subsidiary in Germany. In both cases, dividends could be transferred within the group without being taxed, but only where the indirect subsidiary was established in Germany could financing costs relating to the dividends paid by that subsidiary be deducted. This difference in treatment might dissuade German resident parent companies from carrying on their activities through the intermediary of indirect subsidiaries established in other Member States[1514].

The German government argued that the situation of a resident parent company with a non-resident indirect subsidiary was not comparable to that of a resident parent company with a resident indirect subsidiary. Whereas dividends paid by a German indirect subsidiary were included in the basis of assessment of the parent company, dividends paid by an Austrian indirect subsidiary were exempt from tax. The restriction on the deductibility of the financing costs was the corollary of the non-taxable nature of dividends from abroad. Accordingly, the fact that Keller Holding did not benefit from the method of offsetting tax was due to the fact that Keller Wien was established in Austria and, therefore, subject to Austrian corporation tax[1515].

The ECJ disagreed. The Court held that, in respect of the taxation of inbound dividends, *"parent companies subject to unlimited tax liability in Germany are in a comparable position whether they receive dividends from an indirect subsidiary established in that Member State or from an indirect subsidiary having its registered office in Austria. In both cases, the dividends received by the parent company are, in reality, exempt from tax. Accordingly, a restriction on the deductibility of a parent company's financing costs – as a corollary of the non-taxation of dividends – which affects solely dividends from abroad does not reflect a difference in the situation of parent companies according to whether the indirect subsidiary owned by the latter has its registered office in Germany or in another Member State"*. The Court continues by noting that, in this regard, the fact that indirect subsidiaries established in Austria are not subject to corporation tax in Germany is irrelevant. The different tax treatment introduced by the German measure related to parent companies according to whether or not they had indirect subsidiaries in Germany, even though those parent companies were all German residents. As far as their tax situation is concerned as regards the dividends paid by their indirect subsidiaries, those dividends did not give rise to tax being levied on the parent companies, whether they were derived from indirect subsidiaries taxable in Germany or in Austria[1516].

Accordingly, the basic comparability as explained in *Bosal* and *Marks & Spencer* also holds in the context of the German measure at issue in *Keller*. The German government's argument that the dividends derived from indirect subsidiaries established in Austria were not included in the parent company's basis of assessment does not affect this comparability. As the Court notes, dividends derived from indirect subsidiaries established in Austria were in reality also exempt from tax. As a result, the German government's argument for incomparability was not convincing.

Apart from this argument relating to the dividend income, the German government brought forward the territoriality-argument as it was recognized in *Futura*, but the ECJ dismissed this argument as well. The Court notes that both the dividends derived from the Austrian indirect

[1514] C-471/04, *Keller*, § 34-35.
[1515] C-471/04, *Keller*, § 36.
[1516] C-471/04, *Keller*, § 37-38.

subsidiary and those derived from the German indirect subsidiary were in reality exempt from tax at the level of the parent. Consequently, the different scope of tax liability at the level of the subsidiaries (unlimited v limited taxation), could not affect the comparability at the level of the parents[1517].

Rewe

Rewe concerned the German regime governing the possibility for a resident parent company to deduct losses incurred in respect of write-downs to the book value of its shareholdings in subsidiaries.

The taxpayer, a German resident company, had a subsidiary in the Netherlands. Under German domestic tax law, write-downs to the book value of shareholdings in a German subsidiary could, in principle, be taken into account for tax purposes without restriction as operating expenses of the parent company in calculating its taxable profits. In contrast, write-downs to the book value of shareholdings in a non-resident subsidiary could be taken into account for tax purposes only in limited cases, that is to say, where the negative income stemming from those write-downs was offset by positive income from that other Member State (or where specific conditions with respect to the subsidiary's activity were met).

The ECJ first described the disadvantage: even though a resident parent company could deduct losses stemming from write-downs to the book value of shareholdings in non-resident subsidiaries where those subsidiaries subsequently generated positive income, such a company was deprived of a cash-flow advantage as compared to a resident parent company with a resident subsidiary, as the latter was entitled to have those losses taken into account immediately. As a result, the tax treatment of a resident company with a non-resident subsidiary was less favourable than that of a resident company with a resident subsidiary, which could dissuade resident companies from carrying on its activities through the intermediary of subsidiaries established in other Member States[1518].

The German government argued that a subsidiary established in Germany is not comparable a subsidiary established in another Member State. Subsidiaries are autonomous legal entities in relation to their parent company and they are liable to tax in the State in which they are established. According to the German government, it was likely that the Dutch subsidiary had claimed losses when it declared its taxable profits in the Netherlands.

Unsurprisingly, the ECJ dismisses this argument. The Court first notes that *"the different tax treatment at issue in the main proceedings does not concern the situation of subsidiaries, according to whether or not they are established in Germany, but that of parent companies which are resident in Germany, according to whether or not they have subsidiaries established in other Member States"*[1519].

Such parent companies are in a comparable situation as regards losses incurred in respect of write-downs made to the book value of their shareholdings in subsidiaries, whether the shares are held in subsidiaries established in Germany or in other Member States. In each case, first, the losses are borne by the parent companies and, secondly, the profits of those subsidiaries, whether they come from subsidiaries which are taxable in Germany or from those which are

[1517] C-471/04, *Keller*, § 44 *io.* 43.
[1518] C-347/04, *Rewe*, § 27-31.
[1519] C-347/04, *Rewe*, § 33.

taxable in other Member States, are not taxable in the hands of the parent companies. Consequently, a restriction on the deductibility of such losses by a resident parent company which affects only losses incurred in respect of write-downs to the book value of foreign shareholdings does not reflect an objective difference in the situation of parent companies according to whether their subsidiaries have their seat in Germany or in other Member States[1520]. As a result, the situations were comparable.

This is similar to the line of reasoning followed in *Keller*. After noting the incomparability at the level of the subsidiaries, the Court gives two reasons why this incomparability does not affect the comparability of the parent companies. First, the losses in respect of which the deduction was claimed were borne by the parent companies in both cases. Secondly, neither the profits realised by the resident subsidiary, nor those realised by the non-resident subsidiary were taxable in the hands of the parent companies.

Finally, the Court considers the territoriality-argument as it was recognized in *Futura*[1521]. The Court thus observes that territoriality implies that the Member State in which a parent company is established may tax resident companies on the whole of their worldwide profits but may tax non-resident subsidiaries solely on the profits from their activities in that State. However, that principle in itself does not mean that the parent company's State of residence can refuse to grant an advantage to that company on the ground that it does not tax the profits of its non-resident subsidiaries. The Court then continues, somewhat cryptically: *"the purpose of that principle is to establish, in the application of Community law, the need to take into account the limits on the Member States' powers of taxation. As regards the main proceedings, were the advantage claimed by Rewe to be granted, that would not result in a competing tax jurisdiction becoming involved. It concerns German-resident parent companies which are subject, in that respect, to unlimited liability to tax in that State."* As a result, territoriality could not explain the difference in treatment.

In other words, the Court's reasoning as regards territoriality is in line with its earlier case law, discussed above: the mere fact that the subsidiaries are incomparable, does not mean that the parent companies are incomparable. And the mere fact that it may be justified on the basis of the principle of territoriality to distinguish between residents and non-residents, does not mean that a resident parent company with a non-resident subsidiary is incomparable to a resident parent company with a resident subsidiary. As the Court notes, the comparability at issue concerned *"German-resident parent companies which are subject […] to unlimited liability to tax in that State."*

It may seem strange, however, that the Court points out that the purpose of territoriality is *"to establish, in the application of Community law, the need to take into account the limits on the Member States' powers of taxation."* In the case at issue, if the taxpayer's claim were granted, *"that would not result in a competing tax jurisdiction becoming involved."*

These observations may seem a bit out of place, but, in fact, they merely confirm the Court's basic position as regards territoriality and comparability. The reason why it may be justified to grant benefits exclusively to resident taxpayers and not to non-resident taxpayers is that the former is subject to unlimited tax liability in that State and the latter only to limited tax liability. It is necessary to observe these 'limits on its powers of taxation', as the Court expressed it. Accordingly, territoriality only comes into play where the taxing powers of more

[1520] C-347/04, *Rewe*, § 34.
[1521] C-347/04, *Rewe*, § 68-69.

than one State are involved: the source State, which claims limited tax liability as regards the non-resident's income, and the home State, which claims unlimited tax liability. Because of the non-resident's limited scope of tax liability in the source State, it may be justified for that State to apply different treatment than the treatment accorded to a resident of that State. That was the case in *Futura*: the subject of comparison, a non-resident, was only subject to limited tax liability in Luxembourg and it was therefore justified to deny the benefit granted to the object of comparison, a resident taxpayer (see supra, 2.E.I.A.a.1.c). In *Rewe*, however, there were no competing tax jurisdictions at play. Only the tax jurisdiction of Germany, the home State of both the subject and object of comparison was relevant. Accordingly, the territoriality-justification could not be relied on at this level. Furthermore, the territoriality-argument as applied to the level of the subsidiaries did not mean that there was an incomparability at the level of the parent companies[1522].

f. Papillon[1523]

Under the French group taxation regime, a resident company could render itself the sole party liable for corporation tax due on the overall profits of the group formed by it and the resident companies of which it held, directly or indirectly, at least 95% of the capital. The effect of that regime was that the group of companies was considered as a single legal person for tax purposes. In order for the regime to apply, the companies whose profits were grouped and all intermediary companies had to be subject to corporation tax in France (which was the case for resident companies and non-resident companies with a PE in France). So if a resident parent company wanted to group its profits with those of its resident sub-subsidiary, it was necessary that the subsidiary through which the shares in the sub-subsidiary were held was also a resident (or had a PE in France).

The taxpayer was a French company that held the shares in its French sub-subsidiary through a Dutch subsidiary which did not have a PE in France. Because of the requirements provided for in French domestic law, the French parent company was unable to group its profits with those of its French sub-subsidiary. The question arose whether that gave rise to discrimination contrary to the freedom of establishment[1524].

[1522] The Court's reasoning as regards territoriality was inspired by the § 49 of the Advocate-General's Opinion in *Rewe*, which was a bit more elaborate: *"The purpose of the principle is to establish, in the application of Community law, the need to take into account the limits on the powers of taxation of the Member States. In the case of [Futura], the Member State concerned could not be required to take foreign losses into account because those losses were connected with non-resident taxpayers' income from a foreign source. That is not the situation in the present case. In this case, granting the advantage does not call into question the exercise of a competing tax jurisdiction. It concerns parent companies resident in Germany which are subject, as such, to unlimited tax liability in that country."* As *Futura* concerned losses connected with a non-resident's foreign income, the State in question could claim no taxing jurisdiction with respect to that income, given the limited scope of tax liability. In *Rewe*, however, the taxpayer was a German resident, and therefore subject to worldwide taxation. As a result, the argument that the losses were connected to income in respect of which the Member State in question could claim no taxing jurisdiction was irrelevant in *Rewe*.

[1523] C-418/07, *Société Papillon v Ministère du Budget, des Comptes publics et de la Fonction publique*, 27 November 2008.

[1524] It is interesting to note that the Cour Administrative d'Appel de Paris, when dealing with this case, also considered the issue from the perspective of Art. 24(5) OECD MC. In particular, the court held that no discrimination contrary to the ownership non-discrimination provision of the Dutch/French treaty arose because a French resident parent company with a Dutch subsidiary and a French sub-subsidiary was not comparable to a French resident parent company with a French subsidiary and a French sub-subsidiary. The reason for that incomparability was that the group taxation regime required all the members of the group to be subject to identical rules on the determination of their profits and that those profits could effectively be aggregated at the parent company level (Cour Administrative d'Appel de Paris 24 June 2005, No. 04PA01300: *"pour*

The ECJ first stressed that the question was not whether the Dutch subsidiary should be able to join the French group. The sole question was whether France could refuse the group treatment for a resident parent company and its resident sub-subsidiary because the former held the shares in the latter through a non-resident subsidiary[1525].

The French governent argued that the situations were not comparable because, unlike a resident subsidiary, a non-resident subsidiary is not subject to corporation tax in France. The ECJ dismissed that argument and held that accepting the proposition that a Member State may freely apply a different treatment solely because a company's registered office is situated in another Member State would deprive the freedom of establishment of all meaning. Instead, *"in order to establish whether discrimination exists, the comparability of a Community situation with one which is purely domestic must be examined by taking into account* ***the objective pursued*** *by the national provisions at issue"*[1526].

The objective of the French rules at issue was to treat, as far as possible, a group constituted by a parent company with its subsidiaries and its sub-subsidiaries in the same way as an undertaking with a number of permanent establishments, by allowing the results of each company to be consolidated. According to the ECJ, that objective could be attained both in the situation of a resident parent company that holds resident sub-subsidiaries through a resident subsidiary, and in the situation of a resident parent company that holds resident sub-subsidiaries through a subsidiary established in another Member State. Having regard to the objective of the French rules at issue, the Court therefore concluded that those situations are comparable[1527].

In other words, the Court dismisses the argument that a resident parent company that holds a resident sub-subsidiary through a non-resident subsidiary is incomparable to a resident parent company that holds a resident sub-subsidiary through a resident subsidiary simply because the former subsidiary is not subject to tax in the parent company's State of residence. Instead, it should be assessed in each case individually whether there is a relevant characteristic that differs between the subject and object of comparison. Here, the Court clarifies that the relevance of that characteristic should be assessed from the perspective of the objective of the measure at issue. In the case at hand, the fact that the non-resident subsidiary was not liable to tax in France was not a relevant characteristic from the perspective of the objective of the French measure: there was nothing to prevent the grouping of profits between a resident parent company and its resident sub-subsidiary where the shares were held through a non-resident subsidiary in the same way as where the shares were held through a resident subsidiary.

---

l'application des dispositions de l'article 223 A du code général des impôts qui […] suppose que l'ensemble des membres du groupe soient soumis à des règles identiques de détermination de leurs résultats imposables et que lesdits résultats puissent effectivement être agrégés dans leur totalité au niveau de la société-mère, une filiale française dont le capital est détenu par l'intermédiaire d'une société résidente des Pays-Bas ne saurait être regardée comme étant de même nature, au sens des stipulations précitées, qu'une filiale détenue par une société établie sur le territoire français"). The case was later brought before the Conseil d'Etat (10 July 2007, No. 284785), which referred the question concerning the freedom of establishment to the ECJ without addressing the tax treaty issue.

[1525] C-418/07, *Papillon*, § 17.

[1526] C-418/07, *Papillon*, § 25-27 (emphasis added).

[1527] C-418/07, *Papillon*, § 28-30.

Put briefly, the Court starts from the assumption that two resident companies are comparable. In order to establish that they are not, a valid reason for incomparability must be established. In *Papillon*, the Court stresses that that valid reason should be relevant from the perspective of the objective of the domestic measure at issue.

g. X Holding[1528]

This case concerns the Dutch tax consolidation regime under which tax was levied on a parent company and a subsidiary (or multiple subsidiaries) as if they were a single taxable person. In order for this regime to apply, the parent company was required to hold at least 95% of the shares in the subsidiary and both taxpayers had to request the application of the regime. Tax was then levied on the parent company, with the activities and assets of the subsidiary forming part of the activities and assets of the parent company. The regime could only be applied if both the parent company and the subsidiary were resident in the Netherlands.

The taxpayer, a company established in the Netherlands, was the sole shareholder in a Belgian company. Both companies applied for recognition as a single tax entity in the Netherlands, but the request was dismissed because the subsidiary was not established in the Netherlands. According to the taxpayer, this refusal infringed the freedom of establishment. The Dutch government argued that resident subsidiaries and non-resident subsidiaries were not comparable with regard to the consolidation regime at issue. In particular, a subsidiary which is established in another Member State is not subject to the fiscal jurisdiction of the State in which the parent company is established, with the result that it cannot be integrated into a tax entity subject to tax in the latter State[1529].

The ECJ dismissed the government's argument, pointing out that the comparability of the situations had to be assessed against the backdrop of the aim pursued by the national legislation at issue. In that respect, the Court held that *"the situation of a resident parent company wishing to form a single tax entity with a resident subsidiary and the situation of a resident parent company wishing to form a single tax entity with a non-resident subsidiary are objectively comparable with regard to the objective of a tax scheme such as that at issue in the main proceedings in so far as each seeks to benefit from the advantages of that scheme, which, in particular, allows the profits and losses of the companies constituting the single tax entity to be consolidated at the level of the parent company and the transactions carried out within the group to remain neutral for tax purposes"*[1530].

Once again, the Court thus applies its *Bosal*-argument: since the comparison is between two categories of residents, the starting point is comparability. Consequently, it is up to the Member State concerned to bring forward reasons for incomparability. The Court does not dismiss the possibility that such reasons may indeed lead to incomparability, but it assesses them individually in each case. In the present case, it was not demonstrated that, against the backdrop of the national system at issue, there was a relevant difference between a resident company with a non-resident subsidiary and a resident company with a resident subsidiary[1531].

[1528] C-337/08, *X Holding BV v Staatssecretaris van Financiën*, 25 February 2010.
[1529] C-337/08, *X Holding*, § 21.
[1530] C-337/08, *X Holding*, § 22-24.
[1531] The Court ultimately considered the Dutch regime to be justified on the basis of the balanced allocation of taxing powers. It also considers that the regime is proportionate to that aim, but the Court's reasoning on that point is very remarkable. In particular, the Court does not consider whether the alternative solution, a temporary transfer of losses (subject to subsequent recovery in later years), is a less restrictive measure. Instead, it simply

h. Conclusion

Since *Bosal*, the Court has developed a clear line of case law concerning the comparability of resident companies with resident subsidiaries and resident companies with non-resident subsidiaries. The general idea throughout this case law is the following. As the comparison is between two resident taxpayers, the starting point is that they are comparable. In principle, the incomparability at the level of the subsidiaries does not affect the comparability at the level of the parent companies. The reason is that the parent and the subsidiary are two separate legal entities, which means that the subsidiary's tax position generally does not affect that of the parent.

This conclusion is not altered by the argument in *Keller* that dividends from non-resident subsidiaries were not included in the basis of assessment. As dividends from resident subsidiaries were, in reality, also exempt from tax, there was no objective difference in this regard that could explain the different tax treatment in respect of the deductibility of the financing costs. In a similar fashion, the argument in *Rewe* that there was a relevant difference as regards the possibility to deduct the losses was rejected. In both situations, the losses were borne by the parent company.

Moreover, the idea that the subsidiary's profits are not taxable in the hands of the parent company is of significant importance. In *Bosal*, for instance, the Dutch government argued that the situations at issue could not be compared because the profits of the non-resident subsidiary were not subject to Dutch tax. In contrast, where the subsidiary was a resident of the Netherlands, both the profits of the parent and those of the subsidiary were taxable in the Netherlands[1532]. However, the Court consistently rejects this argument since the subsidiary's profits are not taxable in the hands of the parent in either situation. Consequently, that difference at the subsidiary-level cannot lead to an incomparability at the parent-level.

In this respect, reference should be made to the ECJ's case law on CFC legislation. The effect of such legislation is that, in certain specific situations, (part of) a non-resident subsidiary's income is taxed in the hands of the parent company. Accordingly, the comparison in CFC-cases is made between a resident company with a resident subsidiary and a resident company with a non-resident subsidiary, whereby in the latter case (part of) the subsidiary's income is taxed in the hands of the parent company[1533]. Are those cases helpful to clarify the issue in *Bosal*-type cases that the subsidiary's income is not taxable in the hands of the parent company? Clearly, that is not the case, since the taxability of the subsidiary's profits in the parent company's hands is precisely the disadvantage at issue in CFC-cases. That is to say, the parent company with a non-resident subsidiary is taxed on (part of) the subsidiary's income, whereas the parent company with a resident subsidiary is not. As a result, it is impossible to derive any consequences from such cases as regards the impact of this aspect on the comparability-test. The disadvantage itself cannot be taken into consideration as such to determine comparability[1534].

---

states that the denial of a temporary transfer of losses is also justified on the basis of the balanced allocation of taxing powers and that Member States are not required to grant the same treatment to non-resident subsidiaries as to foreign PEs (which were entitled to the temporary transfer of losses) since they are not comparable. On this issue, see *Confédération Fiscale Européenne*, "Opinion Statement of the CFE on X Holding (C-337/08)", *European Taxation* 2011, 150-152.

[1532] C-168/01, *Bosal*, § 18.

[1533] See, for instance, the vertical aspect of C-196/04, *Cadbury Schweppes*, discussed in 2.E.I.A.b.9.e.1.

[1534] As a simple example: assume that a court considers two employees to be comparable, because they both earn more than EUR 20,000, because they are both employed in the public service, and because they are both

Finally, these cases illustrate that the Court has some difficulties with the concept of territoriality. The Court recognizes that the difference between a resident's unlimited tax liability and a non-resident's limited tax liability has some effect on the discrimination-analysis, but it is not always clear where this effect should be situated. That is to say, it is unclear whether the Court considers territoriality to be an aspect of comparability or a justification-ground. As noted above, it is impossible to accept that territoriality affects the comparability of residents and non-residents since the scope in tax liability is inextricably linked with the comparative attribute (residence). Consequently, that argument should only be taken into account in the justification-test. The same is true in *Bosal*-type cases, where the comparison is between a resident company with a non-resident subsidiary and a resident company with a resident subsidiary. Here, the comparative attribute is the place of residence of the taxpayer's subsidiary. Clearly, the subsidiary's scope of tax liability is inextricably linked with that comparative attribute so the territoriality argument should be disregarded in the comparability-analysis.

The reason why the Court seems to give lip service to the idea that territoriality may affect comparability is that the national governments defending the challenged measure consistently rely on the argument that the situations are rendered incomparable because of the different scope of tax liability at the subsidiary level. It is unfortunate that the Court uses a variety of different formulations to dismiss that argument. It would be clearer to simply state that comparability cannot be affected by factors inextricably linked to the comparative attribute. Of course, it is possible that the territoriality argument is invoked as a justification ground (see 2.F.III) but that is not the same as saying that it renders the situations incomparable.

5. The tax treatment of resident subsidiaries with a non-resident parent company: discrimination on the basis of the parent company's seat

a. Metallgesellschaft[1535]

This case concerns the U.K. group election regime, which was already discussed in Part II, 2.F.II.D.d, in the context of the *Boake Allen*-case. For a discussion of the mechanism underlying the U.K. regime, I refer to what was said there.

The taxpayer in *Metallgesellschaft* was a U.K. resident company that paid dividends to its German parent company. The U.K. resident subsidiary paid ACT on that distribution and subsequently set off that ACT against the MCT for which it was liable.

According to the taxpayer, the U.K. regime gave rise to discrimination because it was impossible for a resident subsidiary with a non-resident parent company to make a group income election, which would have enabled the subsidiary to avoid payment of ACT. In contrast, resident subsidiaries with a resident parent company could make a group income

---

married. In order to assess what the impact of the first factor (the gross income) is on their comparability, one could look for cases that deal with similar issues. However, it would not be helpful to consider cases where an employee specifically argues he is being discriminated against because he earns less than EUR 20,000, while another employee earns more than EUR 20,000. As the disadvantage in the latter case concerns precisely the amount of gross income, the difference in the amounts of gross income cannot affect the comparison.

[1535] Joined cases C-397/98 and C-410/98, *Metallgesellschaft Ltd and Others, Hoechst AG, Hoechst UK Ltd v Commissioners of Inland Revenue*, 8 March 2001.

election, as a result of which they were able to retain, until the date when the MCT was due, the sums which they would otherwise have had to pay as ACT on the distribution of dividends to their parent company. As a result, resident subsidiaries with a non-resident parent company suffered a cash-flow disadvantage as compared to resident subsidiaries with a resident parent company.

The U.K. government argued that there was no discrimination because the situation of resident subsidiaries of resident parent companies was not comparable to that of resident subsidiaries of non-resident parent companies. Where a resident subsidiary with a resident parent company made a group income election, the subsidiary was relieved of the obligation to pay ACT when paying dividends to its parent company, but that payment was merely deferred, as the parent company, being resident, was itself required to pay ACT when it made distributions subject to ACT. The obligation to pay ACT when paying dividends was therefore transferred from the subsidiary to the parent company and the subsidiary's exemption from ACT was offset by the parent company's liability to ACT.

By contrast, if resident subsidiaries and their non-resident parent companies were able to benefit from the group election regime, no ACT at all would be paid in the U.K. The subsidiary would be exempt from payment of ACT when paying dividends to its parent company, but that exemption would not be offset by any subsequent payment of ACT by the non-resident parent company when it made distributions, since the parent company was not subject to U.K. corporation tax or, therefore, to ACT[1536].

This is an application of the territoriality-argument, as it was recognized by the Court in *Futura* (see supra)[1537]. In particular, the effect of the group election regime was simply to shift the charging of ACT to another level within the same group of companies. However, if the exemption from ACT under the group income election were granted to subsidiaries of non-resident parent companies, no ACT would be charged in the U.K. on transactions within the group since the other group companies were not subject to corporation tax in the U.K. In other words, the argument is that the resident subsidiary of a non-resident parent company is not comparable to the resident subsidiary of a resident parent company, because the non-resident parent company is not subject to worldwide taxation in the U.K.

As it did in the cases discussed in 2.E.I.A.b.4, the ECJ dismissed this argument. First, the Court noted that ACT was no tax on dividends but rather an advance payment of corporation tax. As a result, it was incorrect to suppose that extending the group income election regime to resident subsidiaries of non-resident parent companies would allow the subsidiary to avoid paying any tax in the U.K. on profits distributed by way of dividends. Eventually, when the subsidiary's MCT liability falls due, it pays the proportion of corporation tax which it did not have to pay when distributing dividends to its parent company under the group income election. As a resident subsidiary of a non-resident parent company is liable to MCT in the U.K. in the same way as a resident subsidiary of a resident parent company, there is no possibility for the former to avoid paying any tax on the distributed profits. Consequently, to extend the group income election regime to resident subsidiaries of non-resident parent companies would do no more than allow them to retain the sums which would otherwise be

[1536] Joined Cases C-397/98 and C-410/98, *Metallgesellschaft*, § 47-48.
[1537] See also the observation made by the Dutch government, discussed in the next footnote.

payable by way of ACT until such time as MCT falls due. They would thus enjoy the same cash-flow advantage as resident subsidiaries of resident parent companies[1538].

Secondly, the fact that a non-resident parent company will, unlike a resident parent company, not be subject to ACT when it in turn pays out dividends cannot explain why the resident subsidiary of a non-resident parent should not be entitled to benefit from the exemption from payment of ACT when paying dividends to that parent company. The fact that a non-resident parent company is not liable to ACT is due to the fact that it is not liable to corporation tax in the U.K. (because of its non-residence). The Court concludes: *"Logic therefore requires that a company should not have to make advance payment of a tax to which it will never be liable"*[1539].

In conclusion, the Court holds that *"the difference in the tax treatment of parent companies depending on whether or not they are resident cannot justify denial of a tax advantage to subsidiaries, resident in the United Kingdom, of parent companies having their seat in another Member State where that advantage is available to subsidiaries, resident in the United Kingdom, of parent companies also resident in the United Kingdom, since all those subsidiaries are liable to MCT on their profits irrespective of the place of residence of their parent companies"*[1540].

This is the same reasoning as followed in *Bosal*-type cases, described in 2.E.I.A.b.4. The Court first acknowledges that resident parent companies and non-resident parent companies are incomparable. However, that incomparability does not affect the comparability at the level of the subsidiaries. Both subsidiaries are residents and therefore, in principle, comparable. The specific nature and function of the ACT does not affect this conclusion: ACT is an

[1538] There is an additional line of reasoning with regard to tax avoidance, which is interwoven with the Court's comparability-analysis. The Dutch government had argued that the U.K. regime was in accordance with the principle of territoriality. Even though the U.K. waived levying ACT on the subsidiary, it did not renounce its right to that tax, since the effect of the regime is simply to shift the charging of ACT to another level within the same group of companies. By contrast, if the exemption from ACT under a group income election were granted to subsidiaries of non-resident parent companies, no ACT would be charged in the U.K. on transactions within the group since the other group companies are not subject to corporation tax in the U.K. According to the Dutch government, *"that would be tantamount to tax avoidance"* (Joined Cases C-397/98 and C-410/98, *Metallgesellschaft*, § 49). As noted here, the Court's first response to this argument is that the subsidiary eventually pays the same amount of MCT, regardless of the parent company's place of establishment. As ACT was actually an advance payment on corporation tax for the resident subsidiary, there was no possibility for the subsidiary of a non-resident parent company to avoid its obligation to pay MCT. The only effect of extending the group election regime to such subsidiaries would be that they enjoyed the same cash-flow advantage as subsidiaries of resident companies. Moreover, the Court notes that the establishment of a company outside the U.K. does not, of itself, necessarily entail tax avoidance, since that company will in any event be subject to the tax legislation of the State of establishment. Finally, the Court observes: *"it would seem that it is acceptable to the tax law of the U.K., so far as resident parent companies are concerned, for no ACT to be paid ultimately by companies which have made a group income election. In certain cases, the parent company to which dividends have been distributed under such a taxation regime will not itself pay any ACT. In particular, it may make no distribution liable to ACT or it may make distributions under the group income election which would otherwise have been liable to ACT. The liability of a resident parent of a resident subsidiary to pay ACT does not, therefore, even necessarily offset the release, arising from the group income election, of its subsidiary from the obligation to pay ACT"* (Joined Cases C-397/98 and C-410/98, *Metallgesellschaft*, § 57-58). As a result, the mere observation that the measure was intended to curb abuse, does not affect the comparability of the situations.

[1539] Joined Cases C-397/98 and C-410/98, *Metallgesellschaft*, § 55-56. This can be seen as an application of the idea that characteristics which are inextricably linked with the comparative attribute (here, the parent company's place of residence) cannot render the situations incomparable.

[1540] Joined Cases C-397/98 and C-410/98, *Metallgesellschaft*, § 60.

advance payment of MCT, and both subsidiaries are (eventually) liable to the same amount of MCT.

There is an interesting parallel to be drawn between this case and *Boake Allen*, discussed in Part II, 2.F.II.D.d (see Part IV, 1.A.IV.B).

b. X and Y[1541]

Two Swedish residents, X and Y, held shares in X AB, a Swedish company. X and Y wanted to transfer those shares at their acquisition cost to Z AB, another Swedish company, which was a subsidiary of Y SA, a Belgian company.

When shares were transferred at undervalue, Swedish tax law provided that the transferor was subject to tax. The taxable base was the difference between the market value of the shares at the moment of transfer and the acquisition cost for the transferor. In this context, a distinction was made as regards the timing of the taxation. When the shares were transferred to a non-resident company in which the transferor (directly or indirectly) held shares, the transfer was taxed immediately. The same was true when the shares were transferred to a Swedish limited company in which such a non-resident company had a (direct or indirect) holding. In contrast, when the shares were transferred to a Swedish company with no foreign ownership in which the transferor (directly or indirectly) held shares, there was no immediate taxation. Instead, the taxation of the capital gain was deferred until the transferor disposed of his holding in the company to which the shares were transferred.

X and Y argued that this distinction fell foul of the free movement provisions, since the transferor's liability to tax was deferred when the shares were transferred to a Swedish company, but not when the shares were transferred to a non-resident company or to a Swedish company in which a non-resident company held shares.

The Court held that the cash flow disadvantage resulting from this distinction restricted the freedom of establishment[1542]. First, with respect to shares transferred to a non-resident company, the refusal of the deferral was likely to deter Swedish residents from establishing a company in another Member State. Secondly, with respect to shares transferred to a resident company in which a non-resident company had a holding, the freedom of establishment of the non-resident company was restricted. In this regard, the Court held that accepting the proposition that a Member State may refuse tax benefits by reason of the fact that the parent company of the transferee is established in another Member State would deprive the freedom of establishment of all meaning[1543].

In other words, the mere fact that a resident company has a non-resident parent company does not render it incomparable to a resident company which has no non-resident parent company.

[1541] C-436/00, *X and Y v Riksskatteverket*, 21 November 2002.
[1542] Given the scope of the Swedish measures at issue, the issue was also addressed from the perspective of the free movement of capital. The Court reached the same conclusion in that regard as it did in the context of the freedom of establishment (C-436/00, *X and Y*, § 66-74).
[1543] C-436/00, *X and Y*, § 36-39.

c. Thin Cap GLO[1544]

This case concerned the U.K. thin cap rules. Under those rules, any interest paid by a U.K. resident company on a loan was treated as a distribution of profits to the extent that the interest represented more than a reasonable commercial return on the loan. Accordingly, the amount by which the interest exceeded a reasonable commercial return was not deductible from the borrowing company's taxable profits, but was treated as a dividend. That rule applied both when the loan was granted by a U.K. resident company and when it was granted by a non-resident company.

Moreover, any interest paid by a resident company to a non-resident company belonging to the same group of companies was treated as a distribution of profits, even where the interest represented a reasonable commercial return on the loan in question. That rule applied to loans made by a non-resident company to a resident subsidiary of which the former owned 75% of the capital or where both companies were 75% subsidiaries of a non-resident third company[1545].

The question arose whether this distinction between resident subsidiaries that paid interest to resident parent companies and resident subsidiaries that paid interest to non-resident parent companies fell foul of the freedom of establishment. The disadvantage consisted of an increase in tax liability for the borrowing company, because it could not deduct the amount of interest paid from its taxable profits, and because, by treating that interest as a distribution, the company could be liable to advance corporation tax when that transaction took place.

The U.K. government argued that the regime did not give rise to discrimination, as it merely distinguished between situations which are not comparable. More specifically, the government contended that a group of companies could organise a transfer of profits only in a multinational context, by financing a resident subsidiary by a loan rather than by equity capital, thereby transferring the resident subsidiary's profits to another State where they would be subject to a lower rate of tax, with the result that the profits would not be taxed in the U.K. Furthermore, only a non-resident parent company has the choice of establishing itself in the State in which interest is taxed at a particularly low rate, or is exempt from tax[1546].

The ECJ dismisses this argument and holds that *"the difference in treatment to which the subsidiaries of non-resident parent companies are, by virtue of legislation such as the legislation at issue in the main proceedings, subjected in comparison with subsidiaries of resident parent companies is capable of restricting freedom of establishment even if, from a tax perspective, the position of a multinational group of companies is not comparable to that of a group of companies, each of which is resident in the same Member State."* The Court acknowledges that, within a group of companies, the risk that the financing of a subsidiary will be structured in such a way that profits are transferred to a State where they are subject to a lower rate of tax does not normally arise if all of the companies in question are subject to the same rate of tax in the same Member State. However, that does not mean that the rules adopted by a Member State for the specific purpose of dealing with the situation of

[1544] C-524/04, *Thin Cap GLO*, 13 March 2007.
[1545] The regime was amended in 1995, 1998 and 2004, but these changes do not affect the comparability-issue. See C-524/04, *Thin Cap GLO*, § 10-15 and 41-45.
[1546] C-524/04, *Thin Cap GLO*, § 58.

multinational groups may not, in some cases, constitute a restriction on the freedom of establishment of the companies concerned[1547].

> The Court also refers to its earlier judgment in *Lankhorst-Hohorst*, where it was held that a difference in treatment between resident subsidiaries based on the place of establishment of their parent company constitutes a restriction on freedom of establishment, since it makes it less attractive for companies established in other Member States to exercise freedom of establishment. In that judgment, the Court considered a German thin cap-rule to infringe the freedom of establishment without, however, explicitly addressing comparability[1548]. The reason for the absence of a comparability-analysis in *Lankhorst-Hohorst* is, most likely, that the parties did not raise any specific arguments with respect to comparability. Since the Court starts from the assumption that two resident companies are comparable, there is no reason to address the comparability-issue when no reasons for incomparability are advanced.

Basically, the Court's approach in *Thin Cap GLO* is the same as that in *Metallgesellschaft* (see supra)[1549]. The Court acknowledges that the situation of a multinational group is not comparable to that of a group of companies, each of which is resident in the same Member State. However, that incomparability does not affect the comparability at the subsidiary level. Here, the Court thus contrasts the incomparability at the group level with the comparability at the subsidiary level, while in *Metallgesellschaft*, it contrasted the incomparability at the parent company level with the comparability at the subsidiary level. However, the different use of words in both cases is of little practical importance: the reason why there is an incomparability at the group level in *Thin Cap GLO* is precisely that the parent companies are incomparable (one being a resident, the other a non-resident). Accordingly, the Court rejects the incomparability-argument in *Thin Cap GLO* on the same grounds as it did in *Metallgesellschaft*: there is no reason why the incomparability of the parent companies should affect the comparability of the resident subsidiaries[1550].

d. Conclusion

The Court's approach in cases involving discrimination on the basis of the parent company's seat is the same as in cases involving discrimination on the basis of the subsidiary's seat. The starting point is the assumption that two residents are comparable. If there are no valid reasons for incomparability, distinguishing between them may lead to discrimination.

In none of the cases discussed here did the Court accept reasons for incomparability. As in the case law discussed in 2.E.I.A.b.4, the mere fact that a non-resident parent company is not subject to tax in the State of residence of its (resident) subsidiary does not mean that that subsidiary is incomparable to the resident subsidiary of a resident parent company. In order

[1547] C-524/04, *Thin Cap GLO*, § 59-60.
[1548] C-324/00, *Lankhorst-Hohorst*, 12 December 2002.
[1549] Including an aspect relating to tax avoidance, interwoven with the comparability-reasoning, and particularly the observation that *"within a group of companies, the risk that the financing of a subsidiary will be structured in such a way that profits are transferred to a State where they are subject to a lower rate of tax does not normally arise if all of the companies in question are subject, in the same Member State, to the same rate of tax"* (C-524/04, *Thin Cap GLO*, § 60). In other words, the risk of tax avoidance is greater where the parent company is not established in the subsidiary's State of residence, but that does not affect the comparability at the subsidiary-level.
[1550] In C-105/07, *Lammers & Van Cleeff*, 17 January 2008, the subsequent ECJ case dealing with thin cap-rules, the territoriality-argument was not relied upon. As a result, comparability did not come up for discussion in the Court's analysis.

for the situations to be incomparable, there must be a difference between them as regards a characteristic that is relevant from the perspective of the domestic measure at issue.

6. The taxation of dividends: the susceptibility to double taxation as the relevant characteristic

a. Introduction

The taxation of cross-border dividends is one of the most fundamental issues in the ECJ's body of case law on direct taxation. Because dividend income has normally been subject to corporate tax at the level of the company distributing its profits, double taxation issues may arise where the recipient of the dividend is taxed on that income. Multiple layers of taxation are possible if the dividend passes through a number of hands before reaching the ultimate beneficiary. In a purely domestic context, there are a number of relatively simple ways to resolve such disadvantages but the situation is made significantly more difficult where different Member States are involved, each of which has retained a considerable degree of sovereignty in direct tax matters.

These difficulties are reflected in the ECJ's case law concerning double taxation on dividend payments which, at first sight, seems confusing and inconsistent[1551]. The ECJ apparently distinguishes inbound situations from outbound situations and cases concerning dividend payments from cases concerning interest payments, which creates the impression that the ECJ's body of case law in this field is fragmented and devoid of coherence. However, a close reading of the relevant case law reveals a continuing search for an intricate balance between the desire to further economic integration by abolishing tax discrimination and the need to preserve States' tax autonomy.

In the following paragraphs, an attempt will be made to find a 'leitmotif' in the relevant case law. First, the case law on inbound dividends will be considered, i.e. the situation where a resident of a Member State receives dividends from a company established in another Member State. Secondly, the case law on outbound dividends will be considered, i.e. the situation where a company established in a Member State distributes dividends to a shareholder established in another Member State.

b. Inbound dividends: the susceptibility to double taxation as the relevant characteristic

The starting point in the case law concerning inbound dividends is the line of reasoning set out in *Verkooijen*[1552], *Lenz*[1553] and *Manninen*[1554]. The core issue in these cases is the comparability of shareholders residing in State A in receipt of dividends of a State A company and shareholders residing in State A in receipt of dividends of a State B company, **as regards the application of the tax laws of the shareholders' State of residence (State A)**.

[1551] E.g. M. GRAETZ and A. WARREN, "Dividend taxation in Europe: When the ECJ makes tax policy", *C.M.L.R.* 2007, 1577-1623.
[1552] C-35/98, *Staatssecretaris van Financiën v Verkooijen*, 6 June 2000.
[1553] C-315/02, *Anneliese Lenz v Finanzlandesdirektion für Tirol*, 15 July 2004.
[1554] C-319/02, *Petri Manninen*, 7 September 2004.

1. Verkooijen

At issue in *Verkooijen* was the Dutch legislation on the taxation of dividends. When companies established in the Netherlands distributed dividends, they were obliged to withhold 'dividend tax', i.e. a deduction at source by way of income tax. The dividend tax was a final tax if the dividends were paid to a non-resident. By contrast, the dividend tax was a payment on account of income tax if the dividends were paid to a resident. When income tax on aggregate income was assessed in the hands of the resident shareholder, that payment on account was set off against the tax payable on aggregate income. The Dutch legislation at issue exempted income from shares on which Dutch dividend tax had been levied (i.e. income from shares in companies established in the Netherlands) from income tax, up to a specified amount[1555].

The dividend exemption, and its limitation to dividends paid by companies established in the Netherlands, served a twofold purpose. First, the exemption was intended to raise the level of undertakings' equity capital and to encourage investment in Dutch shares. Secondly, in particular for small investors, the exemption was intended to compensate for the double taxation which would otherwise result from the levying of both corporation tax on the distributing company's profits and individual income tax on the dividends received by the shareholders.

Mr Verkooijen was a resident of the Netherlands who received dividends from a Belgian company. A 25% Belgian withholding tax was retained on payment of the dividends. Because the dividend was not paid by a Dutch company, the Dutch dividend exemption regime was inapplicable, with the result that the dividend was included in Verkooijen's taxable income for purposes of the individual income tax in the Netherlands.

According to the ECJ, the Dutch measure dissuaded nationals of a Member State residing in the Netherlands from investing their capital in companies established in another Member State. Moreover, such a provision also restricted companies established in other Member States from raising capital in the Netherlands since the dividends which such companies pay to Dutch residents receive less favourable tax treatment than dividends distributed by a Dutch company. As a result, the Dutch legislation infringed the free movement of capital.

The ECJ does not address the question as to whether dividends distributed by a Dutch company are comparable to dividends distributed by a company established in another Member State. This is remarkable, since the legislation at issue introduces a clear discrimination: a benefit which is granted in domestic situations is refused in cross-border situations[1556]. One might argue that the Court in *Verkooijen* implicitly accepted the

[1555] For a somewhat similar case, where the discrimination was more obvious, see C-406/07, *Commission v Greece*, 23 April 2009. Under the Greek national legislation at issue in that case, dividends distributed by domestic companies were exempt from tax if corporate tax had been paid at the level of the distributing company. In contrast, dividends from foreign companies were taxable in the hands of the resident recipient, who was entitled to a tax credit corresponding to the tax paid abroad (up to the amount of tax which would be due in Greece on the income). However, that credit was not sufficient in certain cases, with the result that Greek tax was sometimes due on the inbound dividends. Given the less favourable treatment of inbound dividends, the ECJ held that the Greek regime infringed both the freedom of establishment and the free movement of capital.
[1556] C-35/98, *Verkooijen*, § 34-36. It has been suggested that the ECJ in *Verkooijen* applies a strict restriction-analysis, rather than a discrimination-analysis, which would explain the absence of the comparability-test. Given the discriminatory nature of the Dutch measure, this would seem very odd. Moreover, the Court's analysis does not gain in depth or clarity by assuming a restriction-perspective (see also R. LYAL, "Non-discrimination and

comparability of the situations. In contrast, the ECJ in *Lenz* and *Manninen* expressly articulated the conditions for comparability in situations involving national measures intended to mitigate economic double taxation on inbound dividends (see infra). The reason for this different approach seems to be that the Dutch government in *Verkooijen*, unlike the Austrian government in *Lenz* and the Finnish government in *Manninen*, did not argue that the situations were incomparable. As a result, the Court apparently paid no mind to this issue.

After having confirmed the existence of a disadvantage in *Verkooijen*, the Court went on to examine possible justifications for the Dutch legislation. In the context of the current study, the fiscal cohesion-argument is the most interesting. This argument will be examined in 2.E.I.A.b.6.b.4.

2. Lenz

The ECJ took the next important step in its case law on inbound dividends in *Lenz*, in which the Court articulated a clear line of reasoning as to the comparability-issue. Mrs Lenz, an Austrian resident, received dividends from a German company. Under the Austrian legislation at the time, Austrian residents receiving foreign dividends were subject to the ordinary income tax on those dividends. The dividend income was thus included in their taxable income and subject to the normal tax rates, the maximum rate of which was 50%. By contrast, an Austrian resident receiving dividends from Austrian companies could choose whether the dividends should be subject to a withholding tax at a flat rate of 25% or whether they should be taxed at a rate equivalent to half of the average tax rate applicable to the aggregate income. The ECJ was asked whether that distinction was compatible with the free movement of capital.

As in *Verkooijen*, the Court first observed that the Austrian legislation had the effect of deterring both Austrian residents from investing their capital in companies established in another Member State and companies established in other Member States from raising capital in Austria[1557]. The Austrian government argued that the situations were not comparable because *"the Austrian authorities collect the tax on the profits which companies established in Austria distribute to their shareholders partly from the companies and partly from the shareholders. In relation to companies established outside their territory, the Austrian authorities are not in a position to levy the tax on revenue from companies in the same way"*[1558]. Accordingly, the ECJ went on to examine whether Austrian residents receiving dividends from Austrian companies were comparable to Austrian residents receiving dividends from foreign companies.

---

direct tax in Community law", *EC Tax Review* 2003, 72). Additionally, the Court applies its traditional discrimination-analysis in the later cases *Lenz* and *Manninen*, which were very similar to *Verkooijen* in most respects (see infra). Perhaps the Court implicitly accepted the comparability of the situations in *Verkooijen*, after which the specific conditions for comparability were set out in detail in *Lenz* and *Manninen*. On the Court's ambiguous use of words as regard to the distinction between discrimination and restriction, see 2.D.V.

[1557] C-315/02, *Lenz*, § 20-21, referring, inter alia, to C-35/98, Verkooijen, § 35.

[1558] C-315/02, *Lenz*, § 28. The Austrian government advanced a similar argument as a justification ground, namely that the need to ensure the effectiveness of fiscal supervision meant that the final withholding tax (at the rate of 25%) could only be applied to Finnish companies distributing dividends. The ECJ dismissed that argument by pointing out that, in cases where withholding at source is impossible, the same final tax could be paid by voluntary payment. Such a procedure could give rise to administrative difficulties, but such difficulties cannot constitute a justification ground (C-315/02, *Lenz*, § 47-48). Additionally, the Austrian government also tried to justify the measure by relying on the fiscal cohesion-argument (see 2.E.I.A.b.6.b.4).

In this respect, the Court observed that the Austrian legislation was designed to attenuate the economic effects of double taxation of company profits arising from the taxation of those profits by way of corporation tax and the taxation of a shareholder, by way of income tax, on the same profits distributed in the form of dividends. However, the Court then notes that both Austrian dividends and foreign-sourced dividends are capable of being the subject of double taxation. In both cases, the revenue is, in principle, subject first to corporation tax and then, to the extent to which it is distributed in the form of dividends, to income tax. For that reason, the ECJ held that the situations were comparable: *"in relation to a tax rule designed to attenuate the effects of double taxation of the profits distributed by the company in which the investment is made, shareholders who are fully taxable in Austria and receive revenue from capital from a company established in another Member State are […] in a situation comparable with that of shareholders who are likewise fully taxable in Austria but receive revenue from capital from a company established in Austria"*[1559].

At first sight, this reasoning might seem remarkable. As indicated earlier, the Austrian government had argued that the situations were incomparable because of the different position in which the Austrian tax authorities were placed in both situations[1560]. More specifically, the Austrian tax authorities collected tax on profits which Austrian companies distributed to their shareholders partly from the companies and partly from the shareholders. By contrast, no tax could be levied from companies established abroad, which meant that another means of levying the tax was necessary in such cases. However, the ECJ does not address this argument directly. Instead of refuting the reason for incomparability that was brought forward by the Austrian government, the ECJ gives a reason for comparability. As both dividends from Austrian companies and dividends from companies established in another Member State were capable of being the subject of double taxation, both categories of income[1561] were found to be comparable in relation to a tax rule designed to mitigate the effects of double taxation on dividends.

As noted before, comparability is, in essence, an inquiry into relevance. Two different factual situations are never fully comparable and never fully incomparable: they will always share some characteristics and differ with regard to other characteristics. When deciding whether two situations are comparable, the single decisive factor is the choice of relevant characteristics. In order to determine whether a characteristic is relevant, one should look at it in the light of the measure under scrutiny. If the relevant characteristics are identical, the situations are comparable. By contrast, if the relevant characteristics are different, the situations are incomparable.

In the case at issue in *Lenz*, the comparison to be made was between Austrian residents receiving dividends from Austrian companies and Austrian residents receiving dividends from companies established in another Member State. The Austrian government advanced a feature which was different between both groups: when an Austrian company distributed dividends, the Austrian tax authorities could levy tax directly from the company. In relation to companies established elsewhere, that was impossible. Apparently, the ECJ did not consider this feature to be relevant in the light of the measure at issue. According to the Court, the

[1559] C-315/02, *Lenz*, § 30-32.

[1560] Interestingly, the ECJ accepted this argument in *Truck Center* as one of the reasons for incomparability (cf. infra).

[1561] And therefore both categories of recipients of such income, i.e. Austrian residents receiving dividends from Austrian companies and Austrian residents receiving dividends from companies established in another Member State.

relevant characteristic was the capability of being subject to double taxation. Given the purpose of the measure at issue, i.e. the mitigation of the economic effects of double taxation of company profits which are distributed by way of dividend, this seems logical.

> It is essential that the comparability is determined by the **susceptibility** to double taxation of the dividends and not by the actual double taxation of those dividends. If the comparability would be determined by the actual double taxation, the Austrian system would constitute discrimination in relation to dividends sourced in Member State A, where a distributing company's profits are subject to tax, but not in relation to Member State B, where a distributing company's profits are not subject to tax. More specifically, an inbound dividend would then only be comparable to a domestic dividend if the source State has actually taxed the profits of the distributing company. If not, there would be no discrimination because the situations are not comparable (i.e. because the inbound dividends are not subject to actual double taxation).
>
> Nevertheless, the Court takes account of the actual occurrence of double taxation in *Manninen* (see infra). In particular, the Court holds there that inbound dividends and domestic dividends are no longer comparable if the source State already eliminates the risk of double taxation[1562]. In that case, inbound dividends are no longer comparable to domestic dividends since the former are no longer susceptible to double taxation.
>
> As pointed out above, taking account of the actual tax treatment in the source State for the purposes of the comparability-test does not seem advisable. That would mean that inbound dividends are sometimes comparable to domestic dividends, but not always. A better approach would be to take account of the tax treatment in the source State in the disadvantage-test. As will be discussed in 2.E.I.B, the Court has articulated strict conditions which must be met for a disadvantage to be offset by a counterbalancing advantage. There is no reason why the situation at issue here – i.e. where the disadvantage (double taxation) is offset by an advantage granted in the source State (removal of double taxation) – should be treated differently.
>
> Perhaps, the Court's remarkable position on this point can be explained by the nature of the Finnish legislation at issue in *Manninen*. The tax benefits at issue in *Verkooijen* and *Lenz* were **not** made dependent on the effective taxation of the distributing company's profits by way of corporation tax. In *Manninen*, however, the tax credit was only granted on the condition that the distributing company had actually paid the tax on its profits (see infra). For the purposes of the coherence-justification, this condition lead the Court to the conclusion that there was a direct link between the tax advantage at the level of the shareholder and the corporation tax at the level of the distributing company (see infra). Most likely, this condition also lead the Court to considering the effect of the Swedish regime in the comparability-test[1563].

It may seem strange that the **purpose** of the measure is taken into consideration here. Traditionally, the ECJ only examines the purpose of the measure at issue in its third step, i.e. the justification-test. More specifically, under the *rule of reason*-doctrine, the measure must be necessary in order to satisfy a mandatory requirement recognised by EU law and it must be proportionate to its aim (see supra). Thus, the reference to the purpose of the measure in *Lenz* (i.e. the mitigation of double taxation) may seem somewhat out of place in the comparability-test. However, the legitimate nature of this purpose is not tested here, nor is the proportionality between the measure and the purpose. The purpose is merely the backdrop against which the relevance of the characteristics is assessed. And that is entirely correct: the

[1562] C-319/02, *Manninen*, § 36.
[1563] See also infra, 2.F.III.B, on whether fiscal cohesion is actually an aspect of comparability.

relevance of a certain characteristic can only be determined by considering it in the light of (the purpose of) the domestic measure in question.

3. Manninen

Under the Finnish legislation at issue in *Manninen*, dividends received by Finnish residents were taxed as revenue from capital at the rate of 29%, irrespective of whether the dividends were received from a Finnish company or from a foreign company. Companies established in Finland paid tax on their profits at the rate of 29%. In order to avoid double taxation of those profits upon distribution of dividends, Finnish resident shareholders receiving dividends from a Finnish company were granted a tax credit equal to 29/71 of the amount of the dividends received. The dividend and the tax credit constituted taxable revenue in the hands of the shareholder. The effect of granting the tax credit was that the total tax on profits distributed by a Finnish company amounted to 29%. Finally, if the corporation tax paid by the Finnish distributing company was less than 29/71 of the amount of dividends distributed during the tax year in question, then the difference was charged to that company by means of an additional tax.

Mr Manninen, a Finnish resident, held shares in a Swedish company. The dividends distributed by the Swedish company to Mr Manninen had already borne corporation tax in Sweden and were also subject to a Swedish tax on revenue from capital by means of deduction at source. Pursuant to the Finnish regime described above, the dividends were subject in Finland to income tax at the rate of 29% and the tax credit was not granted. Under the applicable tax treaty, the tax deducted at source in Sweden was deductible from the income tax due in Finland. The question arose whether the Finnish regime was compatible with the free movement of capital.

As in *Lenz*, the ECJ thus verified whether residents receiving dividends from resident companies were comparable to residents receiving dividends from non-resident companies[1564]. The Finnish government argued that dividends distributed by Finnish companies were fundamentally different in character from dividends distributed by non-resident companies. Profits distributed in the form of dividends by companies established in Finland were subject to corporation tax in Finland, thereby conferring entitlement on the part of a Finnish resident shareholder to the tax credit. By contrast, non-resident companies were not subject to corporation tax in Finland[1565].

[1564] It should be mentioned that the ECJ verified whether there was a disadvantage **before** addressing the comparability-issue. However, the question as to whether a disadvantage exists is traditionally the second step of the ECJ's discrimination-analysis, while the comparability-test is the first step. Nevertheless, the Court often inverts both steps (cf. also, for instance, in *Lenz*), arguably for the sake of clarity. More specifically, it seems that the ECJ wants to have the second step out of the way before addressing the first and third step, which are often closely interwoven. Although the quest for clarity in case-law is a commendable initiative, the importance of the conceptual three-tier nature of the discrimination-analysis should be stressed. As a side-note, it should be mentioned that the ECJ takes the existence of a tax treaty into consideration when examining whether a disadvantage occurs in *Manninen*. More specifically, the Court observes that the applicable tax treaty *"is not capable of eliminating that unfavourable treatment"* (*Manninen*, § 21). This aspect of the *Manninen*-judgment will be addressed in 2.E.I.B.e.2. As will be pointed out later, the ECJ also examined the possible influence of a tax treaty on the discrimination-analysis in *Orange European Smallcap* and the *ACT* case. But in those cases, the question was not whether the tax treaty could remove the disadvantage, but whether the applicability of the tax treaty rendered two situations incomparable. On this point, see 2.E.I.A.b.9.

[1565] C-319/02, *Manninen*, § 30. The French government raised another interesting argument with respect to comparability. Referring to C-250/95, *Futura*, § 18-22, the French government contended that the Finnish legislation conformed to the principle of territoriality and could therefore not be regarded as contrary to the

The ECJ disagreed, thereby applying the same reasoning as in *Lenz*. The Court first observed that the purpose of the Finnish measure was the prevention of double taxation of company profits by granting to a shareholder who receives dividends a tax advantage linked to the taking into account of the corporation tax due from the company distributing the dividends. The ECJ then immediately adds that residents investing in Finland and residents investing abroad are not always comparable in relation to such a measure. In particular, the situations would be **incomparable** *"where the tax legislation of the Member State in which the investments were made already eliminated the risk of double taxation of company profits distributed in the form of dividends, by, for example, subjecting to corporation tax only such profits by the company concerned as were not distributed"*[1566].

As indicated earlier, the comparability-test is controlled by the relevance of the characteristics which are identical in both the object and subject of comparison. Given the purpose of the measure under scrutiny, the relevant characteristic in *Manninen* was the susceptibility to double taxation (as it was in *Lenz*, see supra). If the source State eliminates the risk of double taxation, the Court suggests that the common characteristic disappears, which means that the situations are no longer comparable (on this point, see supra).

That was not the case in *Manninen*: both dividends distributed by a Finnish company and those paid by a Swedish company were, apart from the tax credit, capable of being subject to double taxation. In both cases, the profits were first subject to corporation tax and then – in so far as they were distributed in the form of dividends – to income tax in the hands of the beneficiaries. The Court therefore concluded that where a Finnish resident invested capital in a Swedish company, there was no way of escaping double taxation of the profits distributed by that company. Consequently, *"in the face of a tax rule which takes account of the corporation tax owed by a company in order to prevent double taxation of the profits distributed, shareholders who are fully taxable in Finland find themselves in a comparable situation, whether they receive dividends from a company established in that Member State or from a company established in Sweden"*[1567].

Put briefly, the ECJ's reasoning in *Lenz* and *Manninen* with respect to comparability can be summarized as follows:

In relation to a tax rule designed to mitigate the effects of double taxation of the distributed profits of a company, the situation of residents of a Member State receiving dividends from a

---

Treaty freedoms (C-319/02, *Manninen*, § 31). However, this argument was dismissed by the Advocate-General and by the ECJ. The A.-G. first referred to the *Schumacker*-doctrine, pursuant to which residents and non-residents are, as a rule, not comparable in the context of direct taxation. According to the A.-G., *"the principle of territoriality cited by the French Government is ultimately linked with this finding. As expounded by the Court in [Futura], this principle states that where the taxation of non-residents is concerned only income and expenses arising in the taxing State are to be taken into account, whereas in the case of domestic taxpayers their worldwide income and expenses constitute the basis of assessment to tax. As the present case relates to an individual fully liable to tax, it cannot be deduced from the principle of territoriality that the offsetting of corporation tax paid abroad is precluded"* (§ 41-42 of the Opinion). The ECJ followed suit: *"unlike the legislation at issue in [Futura], the Finnish tax legislation cannot be regarded as an emanation of the principle of territoriality. As the Advocate General has pointed out […], that principle does not preclude the granting of a tax credit to a person fully taxable in Finland in respect of dividends paid by companies established in other Member States"* (C-319/02, *Manninen*, § 38). The influence of the territoriality-principle on comparability is discussed in more detail in 2.E.I.A.a.1 and 2.E.I.A.b.4.

[1566] C-319/02, *Manninen*, § 33-34.

[1567] C-319/02, *Manninen*, § 36.

company established in that State is comparable to that of residents of that State receiving dividends from a company established in another Member State, inasmuch as both the dividends deriving from a national source and those deriving from a foreign source may be subject to a series of charges to tax.

> *Where a Member State has a system for preventing or mitigating a series of charges to tax or economic double taxation for dividends paid to residents by resident companies, it must treat dividends paid to residents by non-resident companies in the same way.*[1568]

In other words, the starting point is the comparability of both situations: as both the shareholder of the State A company and the shareholder of the State B company may be subject to double taxation on the dividend income, they are in comparable situations with respect to the application of the regime for the prevention or mitigation of double taxation in their State of residence. The consequence of this comparability is the prohibition of unequal treatment for purposes of this regime, which means that the regime should apply equally to State A- and to State B-dividends.

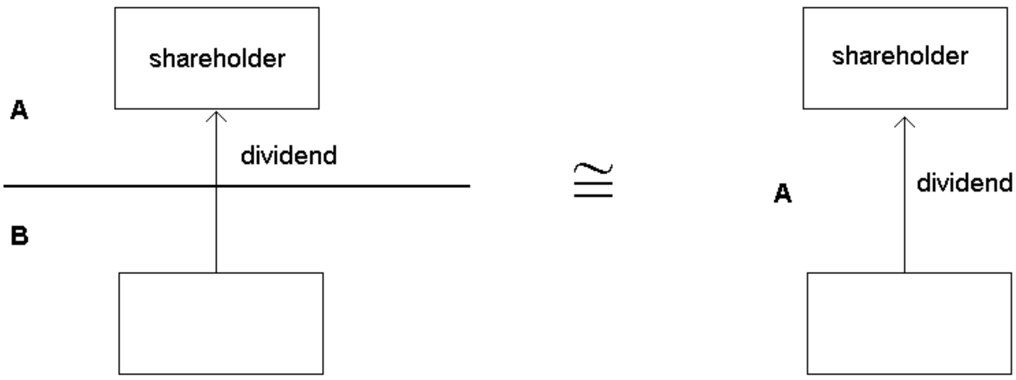


Figure 1: the Lenz/Manninen comparability

4. Are Verkooijen, Lenz and Manninen identical? Fiscal cohesion and inbound dividends

In the *Meilicke*-case[1569] of 2007, the ECJ confirmed *Manninen*. The German regime under scrutiny in *Meilicke* was very similar to the Finnish regime in *Manninen*, so it came as no surprise that the ECJ held that the regime violated the free movement of capital, thereby closely following the *Manninen*-reasoning. In § 40 of *Meilicke*, the Court observes that *"the principles adopted in Verkooijen, which thus clarified the requirements arising from the principle of free movement of capital in respect of dividends received by residents from non-resident companies, were confirmed by the judgments in [Lenz] and in Manninen."* Accordingly, it seems that the ECJ in *Meilicke* places *Verkooijen*, *Lenz* and *Manninen* on the same footing. In particular, the Court apparently suggests that the free movement of capital-issues concerning inbound dividends were resolved in *Verkooijen*, after which the *Verkooijen*-solution was confirmed in *Lenz* and *Manninen*. However, the overview given above suggests that *Lenz* and *Manninen* are not merely duplicates of *Verkooijen*, but rather variations on a common theme.

[1568] C-315/02, *Lenz*, § 31-32; C-319/02, *Manninen*, § 35-36.
[1569] ECJ 6 March 2007, C-292/04, *Meilicke*.

First, I have already indicated that the Court in *Verkooijen* did not address the comparability-issue, whereas it did so quite extensively in *Lenz* and *Manninen*. One could argue that *Lenz* and *Manninen* are an elucidation of *Verkooijen*, in that *Lenz* and *Manninen* clarify the comparability-conditions which must be met in order for the type of disadvantage identified in *Verkooijen* to give rise to discrimination. The reason for the absence of a comparability-analysis in *Verkooijen* was, most likely, that the Dutch government had not argued that the situations were incomparable.

More importantly, however, the three cases are far from identical as to the general methodology used by the Court in assessing overlapping tax situations. More specifically, the question arises whether the tax treatment in the source State is relevant when examining whether the tax legislation of the residence State is compatible with the free movement provisions. In *Verkooijen* and *Lenz*, the Court considers the laws of the defendant State in isolation, whereas it takes both the laws of the source State and the residence State into account in *Manninen*. That issue will be addressed here.

As a preliminary remark, it might be interesting to address the place of this methodological issue in the Court's three-tier analysis. At first sight, it seems obvious that the tax treatment in other Member States mainly affects the second step, i.e. the question as to the existence of a disadvantage. In particular, Member States could argue as a defence against accusations of tax discrimination that the disadvantage caused by their tax laws is compensated for by advantages available in another Member State (e.g. in the non-resident's home State, in the source State of the cross border payment, etc.). In other words, the disadvantage only exists when one considers the defendant State's legislation in isolation. By contrast, when the *overall* tax position of the taxpayer is considered, the disadvantage disappears because of offsetting advantages in other Member States[1570]. Since there is no disadvantage, there is no discrimination. However, as will become apparent throughout the case law discussed below, this issue is mainly addressed in the justification-test, namely as an element of the fiscal cohesion-argument[1571].

The fiscal cohesion-argument can be seen as an attempt to mitigate the rather strict nature of the ECJ's discrimination-test in the area of direct taxation. More specifically, the Court generally refuses to take account of other rules which might offset the disadvantage incurred by the taxpayer[1572]. By carving out the legal provisions that might violate the free movement provisions, the ECJ creates a clear analytical framework without outside interference, but this also brings about the risk of inflexibility (e.g. by disregarding the fact that a measure which is seemingly discriminatory as regards non-residents is actually designed to remove an existing unjustified advantage for non-residents or to counterbalance an existing disadvantage for residents). The fiscal cohesion-argument allows for the measure under scrutiny to be considered against the broader backdrop of the tax system surrounding the measure, and makes it possible to take account of the necessary balance of the legal fabric as a whole. In the

[1570] This argument has come up for discussion several times throughout the ECJ's case law. The relevant case law will be discussed in 2.E.I.B.c and 2.E.I.B.d.

[1571] The tax treatment in the source State has also come up for discussion in the comparability-test, as demonstrated by *Manninen*: in the event where the source State eliminated the risk of double taxation, the common characteristic (i.e. the susceptibility to double taxation) would disappear, which meant that the situations were no longer comparable (cf. supra). Furthermore, it may be argued that fiscal cohesion should actually be incorporated in the comparability-test, rather than functioning as a justification ground (see infra, 2.F.III.B).

[1572] See the case law discussed in 2.E.I.B.c and 2.E.I.B.d.

present context, the question thus arises how the cohesion of a dividend taxation regime (and, more specifically, the interrelationship between the taxation of the distributing company's profits at the company level and the taxation of the dividends at the shareholder level) could justify the discriminatory denial of a tax benefit to a resident shareholder as regards foreign dividends.

Verkooijen

In *Verkooijen*, the tax treatment of the dividends in the source State comes up for discussion in the context of the Dutch government's argument that the restriction of the exemption to domestic dividends was justified by the need to preserve the cohesion of the Dutch tax system. The basis of this argument was that the tax advantages at issue were designed to mitigate the effects of double taxation of company profits. The exemption was reserved to domestic dividends because only resident companies were taxed in the Netherlands on their profits. Where the distributing company is established in another Member State, *"profits are taxed in that Member State with the result that, in the Netherlands, there is no double taxation to be compensated for"*[1573]. The direct link required for a cohesion-argument to succeed[1574] is not expressly mentioned in the argument of the Dutch government, but it seems clear that such a direct link is perceived between the tax advantages at issue (i.e. the dividend exemption) and the corporation tax on the distributing company's profits. Thus, in order to safeguard the cohesion of the tax system, it would be necessary to maintain that link and to draw the logical conclusion therefrom: no exemption for foreign-sourced dividends, because the profits of foreign companies have not been subject to corporation tax in the Netherlands.

The ECJ dismissed this argument. The Court distinguished *Verkooijen* from *Bachmann* by indicating that, in the latter case, a direct link existed *"in the case of one and the same taxpayer, between the grant of a tax advantage and the offsetting of that advantage by a fiscal levy, both of which related to the same tax."* According to the Court, there was no such direct link in *Verkooijen* between the grant to resident shareholders of an exemption in respect of dividends received and the taxation of the profits of non-resident companies. The only explanation that the Court gives for this assertion is that the income tax at the level of the shareholder and the corporation tax at the level of the distributing company *"are two separate taxes levied on different taxpayers"*[1575].

As a conceptual starting-point, the reasoning on which *Verkooijen* is based is remarkable. The ECJ only takes the taxation of the shareholders into account, without considering the tax treatment of the distributing company. When an economic operator decides where to invest, he will take the overall tax burden into account, i.e. the overall combination of the tax treatment in the source State and the residence State. In the ECJ's reasoning, however, the possible interrelationship between taxes levied at the level of the distributing company and taxes levied at the shareholder-level is disregarded: the question whether the tax treatment of the shareholders is compatible with the free movement provisions does not seem to be affected by arguments concerning the taxation at the company level, even though the latter taxation may have been levied in lieu of shareholder taxes. The only explanation offerred by the ECJ in this regard is that both levels of taxation concern *"two separate taxes levied on different taxpayers."* This line of reasoning has been criticized for being unlogical[1576].

[1573] C-35/98, *Verkooijen*, § 49-51.
[1574] C-204/90, *Bachmann*, § 21 *et seq.* See 2.F.III.B.
[1575] C-35/98, *Verkooijen*, § 58.
[1576] M. GRAETZ and A. WARREN, *o.c.*, 1596-1597.

However, it should be borne in mind that this assertion was made in the very specific context of the inquiry into the fiscal cohesion-justification, and, more specifically, the question as to whether a direct link existed between the dividend exemption at the level of resident shareholders and the taxation of the profits of non-resident companies. Given the narrow scope of application of the fiscal cohesion-argument, it should come as no surprise that the Court denies the existence of a direct link between both levels of taxation.

The Advocate-General had earlier reached the same conclusion as the Court, but was more elaborate in his reasoning. The Advocate-General also noted that *Verkooijen* concerned two separate taxes (one on company profits, the other on the income of natural persons, with the exemption applying to the latter) concerning two separate persons (the company distributing dividends and the recipient shareholder). Consequently, the Advocate-General finds that there is only an indirect link between the corporate tax, which affects the profits of the distributing company, and the exemption from which the shareholder benefits. The Advocate-General then paraphrases ECJ's case law setting forth the conditions that need to be fulfilled for there to be a direct link: *"the legislature concerned must establish a specific link between the exemption, the tax deduction, and the subjection to tax, offsetting one of these fiscal choices against the other so that the tax authorities can tax one and the same person at different times or in different ways, but always in respect of the same taxable assets or income and always in order to ensure that each taxpayer is treated in a consistent manner."* Since those conditions were not met in the case at hand, the Advocate-General dismissed the cohesion argument[1577].

Interestingly, an earlier opinion of the Advocate-General in *Verkooijen* was based on the assumption that the dividend tax withheld by the distributing company could not be set off by the shareholder against the tax on his aggregate income[1578]. Under that assumption, the Advocate-General considered the measure to be justified by the need to preserve the cohesion of the Dutch tax system, thereby accepting the existence of a direct link[1579]: *"from the economic point of view, the dividend tax and the income tax payable by natural persons […] affect one and the same taxpayer (the recipient of the dividends)"*. Upon learning that the dividend tax deducted at source was taken into account when assessing income tax on the aggregate income of the shareholder, the Advocate-General changed his position on the fiscal cohesion-argument[1580].

The comparison of these two positions therefore seems to imply that the existence of a direct link between the dividend exemption for the shareholder and the dividend tax withheld by the distributing company depends on the deductibility by the shareholder of the tax withheld at source. If the tax withheld cannot be set off by the shareholder against the tax due on his aggregate income, the Advocate-General considers there to be a direct link between both taxes. No such link exists where the tax withheld at source is deductible by the shareholder. This may sound like a paradoxical interpretation of the direct link-requirement, but it can be explained by the assertion quoted earlier, that *"from the economic point of view, the dividend tax and the income tax payable by natural persons […] affect one and the same taxpayer (the recipient of the dividends)."* In other words, where the shareholder is unable to deduct the tax withheld at source, he must bear the economic effects of both the dividend tax and the individual income tax. By contrast, if he can deduct the dividend tax from the tax on his aggregate income, he will no longer bear the economic effects of the dividend tax.

[1577] Opinion of Advocate-General Pergola in C-35/98, *Verkooijen*, 14 December 1999, § 7.
[1578] Opinion of Advocate-General Pergola in C-35/98, *Verkooijen*, 24 June 1999, § 3.
[1579] Opinion of Advocate-General Pergola in C-35/98, *Verkooijen*, 24 June 1999, § 23-27.
[1580] On the basis of the arguments set out in § 7 of the opinion of 14 December 1999, quoted above.

Lenz

The fiscal cohesion-argument used in *Verkooijen* was brought forward in *Lenz* as well. The only difference is that the Austrian government in *Lenz* expressly indicated the direct link necessary to invoke fiscal cohesion. The government thus argued that the advantage at issue (i.e. the lower tax rate) was designed to attenuate the effects of double economic taxation on company profits. As there was a direct economic link between the taxation of the profits of the company and the advantage in question and since only companies established in Austria were subject to corporation tax in Austria, it was justified to restrict that advantage to recipients of Austrian-sourced dividends[1581].

The ECJ dismissed this argument as well. First, the Court repeats the argument it also used in *Verkooijen*: "*tax on the income of physical persons and corporation tax are two distinct taxes which affect different taxpayers.*" Moreover, the Court notes that the Austrian tax legislation did not make the obtaining of the tax advantage enjoyed by Austrian residents on domestic dividends dependent on the taxation of the companies' profits by way of corporation tax[1582].

Furthermore, the ECJ observed that the fiscal cohesion-argument had to be verified in the light of the aim pursued by the measure at issue. According to the Court, the aim pursued by the Austrian tax legislation, the attenuation of double taxation, would not be affected in any way if one were also to give the benefit of the Austrian tax legislation to persons deriving revenue from capital originating in another Member State. "*On the contrary, the fact of reserving the definitive tax rate of 25% and tax rate reduced by half solely for persons deriving revenue from capital of Austrian origin has the effect of increasing the disparity between the overall tax burden on the profits of Austrian companies and that on the profits of companies established in another Member State*"[1583].

Manninen

In bringing forward its fiscal cohesion-argument in *Manninen*, the Finnish government expressly distinguished the case at hand from *Verkooijen*, by observing that, unlike the tax system in *Verkooijen*, there was a direct link between the taxation of the company's profits and the tax credit granted to the shareholder because the tax credit was only granted on condition that the distributing company had actually paid the tax on its profits. If that tax did not cover the minimum tax on the dividends to be distributed, the company was required to pay an additional tax (see supra)[1584]. As indicated earlier, the granting of the tax advantage in *Verkooijen* and *Lenz* was not made subject to the condition that the distributing company had actually paid the tax on its profits. Moreover, the Finnish government added that, if the tax credit were granted for Swedish-sourced dividends, Finland would be obliged to grant a tax advantage in relation to corporation tax that was not levied by Finland, thereby threatening the cohesion of the Finnish tax system.

As in *Lenz*, the ECJ first observed that the fiscal cohesion-argument had to be verified in the light of the aim pursued by the measure at issue, i.e. the prevention of double taxation of company profits distributed to shareholders. This aim was achieved by granting the taxpayer a tax credit calculated by reference to the rate of corporate tax on company profits. Given the

[1581] C-315/02, *Lenz*, § 34.
[1582] C-315/02, *Lenz*, § 36.
[1583] C-315/02, *Lenz*, § 38.
[1584] C-319/02, *Manninen*, § 40.

identical tax rate of 29% on company profits and on dividends, that system resulted in taxing, solely in the hands of resident companies, the profits distributed by them to resident taxpayers, the latter being simply exonerated from tax on the dividends received. Should the tax paid by a resident distributing company turn out to be less than the amount of the tax credit, the difference was charged to that company by means of an additional tax.

The ECJ admits that there was a link between the tax advantage and the offsetting tax levy, but immediately adds that *"such legislation does not appear to be necessary in order to preserve the cohesion of the Finnish tax system."* More specifically, the Court considers that, having regard to the objective pursued by the Finnish tax legislation, the cohesion of the tax system is assured as long as the correlation between the tax advantage granted in favour of the shareholder and the tax due by way of corporation tax is maintained. Therefore, a less restrictive measure which would not threaten the cohesion of the Finnish tax system would be to grant a resident shareholder of a non-resident company a tax credit calculated by reference to the corporation tax owed by that company in its State of residence[1585].

The Court then distinguishes *Manninen* from *Bachmann*. In the latter case, double taxation was avoided by postponing the sole taxation due until the time when the capital constituted by means of the exonerated contributions was paid. Coherence of the tax system necessarily required that, if the Belgian tax authorities were to allow the deductibility of life assurance contributions from taxable income, they had to be certain that the capital paid by the assurance company at the expiry of the contract would subsequently be taxed. In *Manninen*, the situation was different. At the time when the resident shareholder received dividends, the profits distributed had already been subject to taxation by way of corporation tax, irrespective of whether those dividends came from Finnish or from Swedish companies. According to the ECJ, the objective pursued by the Finnish tax legislation (i.e. the elimination of double taxation of profits distributed in the form of dividends), could be achieved by also granting the tax credit in favour of profits distributed in that way by Swedish companies to Finnish residents[1586].

How to reconcile *Verkooijen* and *Lenz* with *Manninen*

The Court's reasoning in *Manninen* as regards the relevance of the source State taxation seems to be a remarkable departure from *Verkooijen* and *Lenz*. The broad statements that "*individual income tax and corporation tax are two distinct taxes which affect different taxpayers"* and that *"the level of taxation on non-resident companies is not relevant when assessing the compatibility of national legislation with the free movement provisions"* are nowhere to be found in *Manninen*. Instead, the Court expressly takes account of the tax treatment in the source State.

Perhaps, the different positions can be explained by the nature of the Finnish legislation at issue in *Manninen*. As explained earlier, the tax benefits at issue in *Verkooijen* and *Lenz* were not made dependent on the effective taxation of the distributing company's profits by way of corporation tax. In *Manninen*, however, the tax credit was only granted on the condition that the distributing company had actually paid the tax on its profits. Apparently, this condition lead the Court to the conclusion that there was a direct link between the tax advantage at the

[1585] C-319/02, *Manninen*, § 46.
[1586] C-319/02, *Manninen*, § 47-48.

level of the shareholder and the corporation tax at the level of the distributing company[1587]. Given the existence of this direct link, it was necessary for the Court, when examining whether one end of the direct link (i.e. the tax advantage) could withstand scrutiny under the free movement provisions, to incorporate the other end of the direct link (i.e. the corporation tax) in its reasoning. Consequently, it was necessary to take the Swedish tax treatment into consideration. Despite the existence of a direct link, however, the cohesion-argument was ultimately dismissed on other grounds, namely on the basis of the proportionality-requirement.

The fiscal cohesion-argument as regards dividend taxation is based on the very simple notion that the tax benefit granted to the shareholder is an appropriate compensation for the corporate tax paid at the level of the distributing company, in order to prevent double taxation of company profits. Take, for instance, a full imputation system, in which a tax credit is granted to the shareholder only to the extent that the distributed profits have already been subject to corporate tax at the level of the distributing company. In such a case, there is an exact balance between the domestic tax levied at the company level and the tax credit granted at the shareholder level. By contrast, non-resident distributing companies have not borne the domestic tax at the company level, which implies that no domestic credit should be granted to the shareholder. This perfect correlation between corporation tax and tax credit is the direct link required for the fiscal cohesion-argument. In other words, a national measure that grants a full imputation credit to resident shareholders in receipt of domestic dividends is suitable for achieving the objective of preventing double taxation of company profits. But as mentioned earlier, this suitability-test is not sufficient to justify the measure. The proportionality-requirement further implies that the measure must not go beyond what is necessary to achieve it (see the general discussion of the rule of reason-doctrine in 1.B.IV). In other words, if a Member State has a choice between different measures to attain the same objective, it should choose the means which least restricts the free movement[1588]. As regards an imputation credit that correlates exactly with the level of taxation at the corporate level, the objective of preventing double taxation of company profits could be attained by a less restrictive measure, namely the grant of the tax credit to all resident shareholders of companies established in a Member State.

Applied to the ECJ's case law: the national tax systems at issue in *Verkooijen* and *Lenz* granted the tax benefit to resident shareholder receiving domestic dividends without having regard to the tax treatment at the company level. Regardless of the tax treatment of the distributing company's profits, the shareholder enjoyed the benefit for domestic dividends. This explains why the ECJ does not consider there to be a direct link between tax benefit and underlying corporate tax[1589] and why the Court decides that the taxes should be considered separately, without any mutual interference on the justification-level[1590]. Put briefly, no direct link exists, which explains why the tax advantage should be considered in isolation, without

[1587] See also the opinion of Advocate-General Kokott in C-319/02, *Manninen*, § 61: *"exceptionally, a link justifying the tax cohesion argument may exist if a charge on one taxpayer is offset by a relief for another. The preconditions for this are that: the tax is levied, if not on the same taxpayer then at least on the same income or the same economic process, and the legal configuration of the system ensures that the advantage accrues to the one taxpayer only if the disadvantage to the other is real and in the same amount."*
[1588] E.g. C-250/95, *Futura*, § 26.
[1589] See C-35/98, *Verkooijen* § 36: *"the Austrian tax legislation does not make the obtaining of the tax advantages at issue enjoyed by Austrian residents on their domestic revenue from capital dependent upon the taxation of the companies' profits by way of corporation tax"*.
[1590] See C-35/98, *Verkooijen*, § 58 and C-315/02, *Lenz*, § 36: *"They are two separate taxes levied on different taxpayers"*.

any interference stemming from underlying tax regimes (whether they be domestic or foreign).

The situation in *Manninen* was different, as the granting of the Finnish tax credit depended on the tax regime at the company level. The relevant provisions ensured a perfect correlation between the amount of tax levied at the company level and the credit granted at the shareholder level. In other words, the Finnish system was entirely consistent. Accordingly, the Court accepted the existence of a direct link between both levels[1591]. Once this existence has been established, the proportionality of the measure is examined by assessing the feasibility of the alternative. Once again, this examination is made against the backdrop of the purpose of the Finnish measure[1592]. In particular, since the measure was intended to prevent double taxation of company profits, the Court holds that the cohesion of the Finnish system is assured as long as the correlation (i.e. the direct link) between the tax advantage at the shareholder level and the taxation at the company level is maintained. In other words, the objective of preventing double taxation is met when the tax advantage granted to the shareholder corresponds to the taxation at the company level. And this taxation at the company level is not limited to domestic corporate tax: double taxation can also arise because of corporate tax levied in another State (i.e. the distributing company's State of establishment). Therefore, if the objective of the measure was to prevent double taxation, then it was possible to implement a less restrictive measure, under which the tax benefits are extended to resident taxpayers receiving dividends from non-resident companies. This would in no way endanger the cohesion of the system, as the correlation between taxation at company level and tax benefit at the shareholder level is maintained. The Court thus concludes that the cohesion of the Finnish tax system would not be threatened by granting resident shareholders a tax credit calculated by reference to the Swedish taxation at the company level. As this would be less of an obstacle to the free movement of capital, the Finnish measure at issue was disproportionate.

5. Kerckhaert-Morres[1593]

Facts and legal issue

Mr and Mrs Kerckhaert-Morres were Belgian residents who received dividends from a company established in France. Under Belgian legislation at the time, dividends were taxable as a separate category of income at a rate of 25%. The Belgian tax on dividends which had been subject in another country to income tax, was reduced beforehand by a fixed percentage of that foreign tax ('*quotité forfaitaire d'impôt étranger*', 'QFIE'). However, that reduction was rescinded in 1988 as regards individuals not acting in the course of their business[1594]. Consequently, individuals receiving dividends from foreign companies were no longer entitled to the tax credit, with the result that such income was subject to taxation at source in the source State and to tax in Belgium at the rate of 25%.

At the relevant time, France operated an imputation system of dividend taxation (i.e. corporation tax at company level was fully or partially imputed onto the income tax due on the dividends at shareholder level, via grant of an 'avoir fiscal' - an imputation credit - to shareholders). Article 15(3) of the Belgian/French tax treaty provided that dividends paid by a

[1591] C-319/02, *Manninen*, § 45.
[1592] C-319/02, *Manninen*, § 45-46.
[1593] C-513/04, *Mark Kerckhaert & Bernadette Morres v Belgium*, 14 November 2006.
[1594] Article 28 of the Law of 7 December 1988, *Official Gazette* 16 December 1988.

French-resident company that would give a right to an imputation tax credit (avoir fiscal) if received by French residents, also gave a right to this tax credit for Belgian-resident individuals, after deduction of withholding tax calculated at a rate of 15% on the gross dividend consisting of the amount of the distributed dividend increased by the tax credit.

Furthermore, Article 19(A)(1) of the Belgian/French tax treaty provided that, when dividends were paid by a French-resident company to a Belgian resident other than a company subject to corporation tax, and when these dividends had been subject to withholding tax in France, the Belgian tax due on the amount net of this withholding tax was reduced by a fixed percentage of foreign tax ('QFIE') that was deductible under the conditions fixed by Belgian law, provided that that percentage could not be lower than 15% of the net amount.

When Mr and Mrs Kerckhaert-Morres received dividends from the French company, the French tax authorities granted them an imputation credit (avoir fiscal) on these dividends. Pursuant to Article 15(3) of the tax treaty, this imputation credit was treated as dividend income, from which a French withholding tax of 15% was deducted. In declaring this revenue in their tax return, the taxpayers claimed the imputation of the QFIE as referred to in Article 19(A)(1), to the amount of 15%. The Belgian tax authorities taxed the revenue at the rate of 25% and refused to grant the imputation of a QFIE, as that imputation had been rescinded for individuals. The question arose whether the Belgian measure violated the fundamental freedoms by subjecting dividends from resident companies and dividends from companies resident in another Member State to the same uniform tax rate, without in the latter case providing for the imputation of tax levied at source in the other Member State.

> Even though Belgium did not distinguish between inbound dividends and domestic dividends, the former were nevertheless subject to higher taxation because of the tax withheld in the source State, which was not taken into consideration for Belgian tax purposes. For instance, a French-source dividend of 100 would be subject to 15% French tax at source, resulting in a net dividend of 85. That net dividend was subsequently taxed in Belgium at 25%, resulting in an after-tax dividend of 63.75. In contrast, a Belgian-source dividend of 100 would only be subject to the Belgian 'layer' of taxation (25%), resulting in an after-tax dividend of 75.
>
> In the case at hand, however, the factual situation was more complex because French also granted the 'avoir fiscal' to Belgian resident shareholders (see supra). A French-source dividend of 100 would thus entitle the Belgian resident shareholder to an avoir fiscal of 50. This gross dividend of 150 was subject to French withholding tax at the rate of 15%, resulting in an inbound dividend of 127.5. After application of the Belgian tax of 25%, the shareholder is left with an after-tax dividend of 95.625. Consequently, a Belgian resident receiving French-source dividends would ultimately be better off than a Belgian resident receiving Belgian-source dividends (see supra: the after-tax dividend would be 75). But that is misleading because the disadvantageous effect of the Belgian regime is offset by the avoir fiscal granted in France. In the proper comparison, the effect of the avoir fiscal should therefore be disregarded.

The ECJ's analysis

In answering this question, the ECJ first distinguishes *Kerckhaert-Morres* from *Verkooijen, Lenz* and *Manninen*. In the latter three cases, there was a different treatment of comparable situations, i.e. a different treatment of dividend income from non-resident companies as compared to dividend income from resident companies. More specifically, a tax benefit which was granted for the latter category of dividend income was refused for the former category of dividend income (see supra). According to the ECJ, *Kerckhaert-Morres* differed from these cases, since the Belgian tax legislation in *Kerckhaert-Morres* did not make any distinction between dividends from companies established in Belgium and dividends from companies established in another Member State. Both categories of dividends were taxed by way of income tax at an identical rate of 25%[1595].

The Court then takes the logical next step, by observing that this identical treatment is not contrary to the fundamental freedoms, since the situations are not comparable. The ECJ first reiterates its traditional position that discrimination may consist not only in the application of different rules to comparable situations but also in the application of the same rule to different situations. However, the Court then goes on by stating that *"in respect of the tax legislation of his State of residence, the position of a shareholder receiving dividends is not necessarily altered, in terms of that case-law, merely by the fact that he receives those dividends from a company established in another Member State, which, in exercising its fiscal sovereignty, makes those dividends subject to a deduction at source by way of income tax"*[1596].

Finally, the ECJ holds that in circumstances such as those of *Kerckhaert-Morres*, the adverse consequences which might arise from the application of the Belgian legislation *"result from the exercise in parallel by two Member States of their fiscal sovereignty."* In that regard, the Court recalls that tax treaties, as referred to in the former Article 293 EC, *"are designed to eliminate or mitigate the negative effects on the functioning of the internal market resulting from the coexistence of national tax systems referred to in the preceding paragraph."* Since EU law, in its current state and in a situation such as that in *Kerckhaert-Morres*, does not lay down any general criteria for the attribution of areas of competence between the Member States in relation to the elimination of double taxation within the Union, *"it is for the Member States to take the measures necessary to prevent situations such as that at issue in the main proceedings by applying, in particular, the apportionment criteria followed in international tax practice. The purpose of the France-Belgium Convention is essentially to apportion fiscal sovereignty between the French Republic and the Kingdom of Belgium in those situations. However, that convention is not at issue in the preliminary reference at hand"*[1597].

On the basis of these arguments, the Court concludes that the Belgian legislation does not fall foul of the fundamental freedoms.

Commentary

In order to understand the ECJ's analysis in *Kerckhaert-Morres*, it is necessary to keep the structure of the Court's arguments in mind. This structure consists of three steps. (1) First, the Court verifies whether the measure is discriminatory because it treats comparable situations differently (§ 16-17), (2) secondly, it verifies whether the measure is discriminatory because it treats incomparable situations identically (§ 18-19), and (3) finally, it considers whether the measure is restrictive (§ 20-23).

(1) First, the Court distinguishes *Kerckhaert-Morres* from *Verkooijen*, *Lenz* and *Manninen*. Whereas the latter three cases concerned a different treatment of comparable situations, the Court holds that no different treatment occurs in *Kerckhaert-Morres*, as Belgium does not make any distinction between domestic dividends and foreign-sourced dividends. As a result,

[1595] C-513/04, *Kerckhaert-Morres*, § 16-17.
[1596] C-513/04, *Kerckhaert-Morres*, § 19.
[1597] C-513/04, *Kerckhaert-Morres*, § 23.

the measure cannot be considered discriminatory on the ground that it treats comparable situations differently.

Given the even-handed nature of the measure, it has to be analysed from two separate perspectives. On the one hand, the measure could be discriminatory because it treats two incomparable situations identically. On the other hand, if there is no discrimination, the measure could nevertheless be restrictive, in that it dissuades the exercise of the Treaty freedoms.

(2) As to the first of these issues, the Court observes that the identical treatment does not give rise to discrimination, since the situations are not incomparable. At first sight, the reason given by the Court to demonstrate this comparability (i.e. absence of incomparability) is odd: *"in respect of the tax legislation of his State of residence, the position of a shareholder receiving dividends is not necessarily altered […] merely by the fact that he receives those dividends from a company established in another Member State, which, in exercising its fiscal sovereignty, makes those dividends subject to a deduction at source by way of income tax."* As in *Lenz* and *Manninen*, the backdrop of the comparison in *Kerckhaert-Morres* is the tax legislation of the taxpayer's State of residence. In *Lenz* and *Manninen*, the purpose of this legislation (i.e. the mitigation of double taxation on dividends) was expressly taken into consideration, whereas no mention of such purpose is made in *Kerckhaert-Morres*. This might be explained by the specific legal context in *Kerckhaert-Morres*. By contrast to the tax systems under scrutiny in *Lenz* and *Manninen*, the Belgian tax regime at issue in *Kerckhaert-Morres* did not grant a tax benefit intended to mitigate double taxation on dividends in domestic situations while refusing it in cross-border situations. Instead, the problem was that both situations were treated identically. It is this identical treatment (i.e. the Belgian measure under scrutiny) which is used by the ECJ as the backdrop for the comparability-anlysis. According to the Court, *"the position of a shareholder receiving dividends is not necessarily altered […] merely by the fact that he receives dividends from a company established in another Member State which […] makes those dividends subject to a deduction at source by way of income tax."* The word 'altered' should be read as 'rendered different'. In other words, the Court holds that the mere fact that a shareholder receives a foreign-sourced dividend, on which tax has been withheld at source, does not mean that such a shareholder finds himself in a different situation than a shareholder receiving a domestic dividend (which would preclude identical treatment of both situations).

As indicated earlier, the *Lenz/Manninen*-comparability concerns the comparability of a shareholder receiving domestic dividends and a shareholder receiving foreign-sourced dividends against the backdrop of a domestic rule designed to mitigate double taxation. This comparability was explained by the susceptibility of both categories of dividends to double taxation. In light of the domestic measure at issue, that susceptibility to double taxation was the relevant characteristic. Since that characteristic was identical for domestic and inbound dividends, the situations were comparable. By contrast, the domestic measure at issue in *Kerckhaert-Morres* was not intended to mitigate double taxation[1598]. As a result, the susceptibility to double taxation was not a relevant characteristic. The Belgian measure at

[1598] Obviously, the deductibility of the QFIE was designed to mitigate double taxation. However, the purpose of that measure did not affect the ECJ's analysis, since it was merely the abolition of the measure as regards individuals that made *Kerckhaert-Morres*-disadvantages possible. So, unlike *Lenz/Manninen*, there was no domestic measure intended to remove double taxation which applied to one situation but not to another (comparable) situation. Instead, there was only a domestic measure that taxed domestic and inbound dividends identically.

issue only intended to subject resident recipients of dividends to income tax[1599]. From the perspective of such a measure, the only relevant characteristic is the receipt of a dividend. And that characteristic is shared by residents receiving domestic dividends and residents receiving inbound dividends. The fact that certain dividends (i.e. foreign-sourced dividends) have been subject to tax at source, is not relevant in that respect. So that fact was not sufficient to render inbound dividends incomparable to domestic dividends. As a result, the identical treatment did not give rise to discrimination, since the situations were comparable.

(3) Finally – and this might seem remarkable – the ECJ observes that the disadvantage incurred by Mr and Mrs Kerckhaert-Morres is due to *"the exercise in parallel by two Member States of their fiscal sovereignty."* Strictly speaking, it could be argued that the Court's analysis was complete after the first two arguments: as the situations were comparable and there was no difference in treatment, there was no discrimination. Nevertheless, the Court proceeds by observing that the disadvantage is due to a disparity, and therefore outside the scope of EU law. As the mere co-existence of disparate national rules in the different Member States cannot be said to violate the fundamental freedoms[1600], the issue exceeds the grasp of the ECJ. Accordingly, one could argue that the discrimination-analysis (i.e. the comparability-test and the disadvantage-test discussed above) was redundant in the case at hand since the Court could have restricted itself to observing that the disadvantage was due to a disparity, and thus, outside the scope of EU law. In other words, the question as to whether the problem is caused by a disparity is actually a preliminary issue, which should be addressed before the Court starts its actual analysis under the fundamental freedoms.

However, this observation should be seen from the perspective of what has been said in 2.D.V.C. As the national measure at issue in *Kerckhaert-Morres* did not distinguish on any basis (unlike the measures at issue in *Lenz* and *Manninen*), one could argue that this measure amounted to a non-discriminatory restriction. More specifically, even though the measure applied without distinction, it nevertheless made the exercise of the Treaty freedoms less attractive (by imposing a double burden on cross-border dividends). Accordingly, if the Court were to transpose its *Cassis de Dijon*-reasoning to this case, the Belgian government would have to recognize the taxation in France and refrain from further taxation in Belgium. However, as discussed in 2.D.V.C, the concept of mutual recognition cannot be transposed to matters of substantive direct taxation. This explains why the ECJ observes that the disadvantage results from *"the exercise in parallel by two Member States of their fiscal sovereignty"*: even though there is a double burden that is liable to hinder cross-border

[1599] This explains why the following apparent contradiction between *Kerckhaert-Morres* and *Lenz/Manninen* is based on an incorrect *a contrario* argument. In *Lenz/Manninen*, there was a domestic measure to mitigate double taxation. As a result, the susceptibility to double taxation of domestic and inbound dividends rendered them comparable. In contrast, there was **no** domestic measure to mitigate double taxation in *Kerckhaert/Morres*. Consequently, one would expect that the susceptibility to double taxation (i.e. the fact that the inbound dividends have been subject to withholding tax in the source State) does **not** lead to comparability. Yet, the Court decides that the fact that a resident shareholder receives a dividend which has been subject to withholding tax in another Member State does not render him **incomparable** to a resident shareholder who receives a domestic dividend. At first sight, this seems contradictory, but that would be an incorrect *a contrario* argument. Indeed, the reason why the susceptibility to double taxation resulted in comparability in *Lenz/Manninen* was that that susceptibility to double taxation was the relevant characteristic from the perspective of the domestic measure, which was intended to mitigate double taxation. Since the measure at issue in *Kerckhaert-Morres* was not intended to mitigate double taxation, the susceptibility to double taxation was not relevant. So that characteristic simply does not affect the comparability-test. Instead, the situations are comparable because the measure is intended to tax dividends received by residents and the relevant characteristic (receiving dividends) is identical among residents receiving domestic dividends and residents receiving inbound dividends.

[1600] E.g. ECJ 12 May 1996, C-336/96, *Gilly*.

activity, this nevertheless goes beyond the scope of the Treaty freedoms because of the particular nature of direct taxation.

Put briefly, *Kerckhaert-Morres* consists of two separate analyses. First, the Court applies a discrimination-analysis in order to determine whether incomparable situations are treated indentically. Secondly, the Court applies a restriction-analysis in order to determine whether the national measure, which applied without any distinction, was nevertheless contrary to the Treaty freedoms because it restricted the exercise of those freedoms.

As a final remark, it is interesting to note that the Court ends its observations concerning the disparity-issue (and, thus, the inability of EU law to remedy the disadvantage) by stating that the Belgian-French tax treaty, which serves to prevent situations of double taxation such as that encountered by Mr and Mrs Kerckhaert-Morres, was *"not at issue in the preliminary reference at hand."* It is not entirely clear what the Court means by this statement. Perhaps the question referred for preliminary ruling was not sufficiently precise. Obviously, the question then arises whether the solution would have been different if the referring court had expressly inquired into the relevance of the applicable tax treaty.

Damseaux[1601]

In *Damseaux*, the Court was given an opportunity to answer this question. In that case, the ECJ was asked once again whether the *Kerckhaert-Morres*-disadvantage violates the free movement provisions. This time, however, the question referred for preliminary ruling expressly concerned the compatibility with the fundamental freedoms of a restriction arising from the tax treaty between Belgium and France, *"which allows partial double taxation of dividends from shares of companies established in France to subsist and which renders the taxation of those dividends more onerous than Belgian withholding tax alone applied to dividends distributed by a Belgian company to a Belgian resident shareholder."*

The Court's judgment in *Damseaux* confirms the *Kerckhaert-Morres* approach. The Court first notes that it is up to the national courts to interpret the provisions of the tax treaty and to establish the obligations which arise under that treaty. The Court does not have jurisdiction to rule on a possible infringement by a contracting Member State of provisions of bilateral treaties designed to eliminate or to mitigate the negative effects of the coexistence of national tax regimes[1602]. Nor may the Court examine the relationship between a national measure and the provisions of a tax treaty, since that question does not fall within the scope of the interpretation of EU law[1603].

The Court nevertheless continues by observing that *"the referring court proceeds from the assumption that the France-Belgium Convention allows a judicial double taxation of dividends distributed by a company established in France to a shareholder residing in Belgium to subsist. The referring court's first question should, therefore, be understood as*

[1601] C-128/08, *Jacques Damseaux v État belge*, 16 July 2009.
[1602] In particular, it could be argued that Belgium was required under Article 19A of the tax treaty to grant resident shareholders of French companies a minimum foreign tax credit of 15%. Even though Article 19A provided that Belgium was required to grant a *"fixed percentage of foreign tax that is deductible under conditions fixed by Belgian law"* and the Belgian QFIE was rescinded as regards individuals in 1988 (see supra), that provision also required the fixed percentage to be at least 15% of the net dividend. But see Parliamentary Question 9 August 1995, *Vr. & Antw.* Kamer 1995-96, No. 10, 912-913 and P. BRAUNS, "Quelques aspects de la Convention préventive de la double imposition belgo-française", *R.G.F.* 1997, 6-7, 163-164.
[1603] C-128/08, *Damseaux*, § 20-22.

seeking to know whether Article 56 EC precludes a bilateral tax convention […] under which the dividends distributed by a company established in one Member State to a shareholder residing in another Member State are liable to be taxed in both Member States, and which does not provide that the Member State in which the shareholder resides be unconditionally obliged to prevent the resulting double taxation"[1604].

In this respect, the Court reiterates that, although direct taxation falls within their competence, Member States must exercise that competence consistently with EU law. In particular, each Member State must organise, in compliance with EU law, its system for taxing distributed profits and, in that context, define the tax base and the tax rate which apply to the shareholder receiving them.

From this, the Court draws two conclusions. First, the dividends distributed by a company established in one Member State to a shareholder residing in another Member State are liable to be subject to judicial double taxation where the two Member States choose to exercise their tax competence and to subject those dividends to taxation in the hands of the shareholder. Secondly, the Court recalls its decision in *Kerckhaert-Morres* that *"the disadavantages which could arise from the parallel exercise of tax competences by different Member States, to the extent that such an exercise is not discriminatory, do not constitute restrictions prohibited by the EC Treaty"*[1605]. In other words, as long as the national legislation does not give rise to discriminatory treatment, disadvantages arising from substantive tax law (i.e. *"the disadavantages which could arise from the parallel exercise of tax competences by different Member States"*) do not come within the scope of the free movement provisions. Consequently, even though substantive tax measures that are truly even-handed may be liable to hinder cross-border activities, they are nevertheless not contrary to the Treaty freedoms because the *Cassis*-style restriction approach cannot be transposed to such measures. In non-tax areas, such measures may very well be considered to infringe the fundamental freedoms because of the double burden they impose, but because of the particular nature of direct taxation, the ECJ is unable to remedy the resulting disadvantages in this field.

In conclusion, the Court holds that, in the absence of any unifying or harmonising EU measures, Member States retain the power to define the criteria for allocating their taxing powers, either in a treaty or unilaterally, particularly with a view to eliminating double taxation. In the present case, it was in accordance with the attribution of taxing powers agreed in the Belgian/French tax treaty that French-sourced dividends distributed to a Belgian resident were liable to be taxed in both States. As EU law does not lay down any general criteria for the attribution of taxing powers in order to eliminate double taxation, it is impossible for the Court to grant priority to either State. Consequently, Belgium was not required under EU law to remedy the disadvantage[1606].

[1604] C-128/08, *Damseaux*, § 23.
[1605] C-128/08, *Damseaux*, § 24-27.
[1606] It could be argued that the outcome of *Damseaux* would have been different if the taxpayer had addressed his claim at France instead of Belgium. More specifically, France had ended its 'avoir fiscal'-regime as of 2005. Instead of that regime, a new mechanism was implemented, which only applied to resident shareholders. For that reason, it has been suggested that the French regime on outbound dividends was contrary to the free movement provisions (see M. DASSESSE, "Double taxation of foreign dividends: the Damseaux case aiming at the wrong target! Criticism should be directed towards France and not Belgium", *EC Tax Review* 2010, 117-122). That issue will not be addressed here.

6. Orange European Smallcap[1607]

1. Facts and legal issue

At issue in *Orange European Smallcap* was the Dutch regime on so-called 'fiscal investment enterprises' (FIEs). FIEs were liable to corporation tax, but their profits were taxed at a rate of 0%. Where an FIE received dividends from a company established in the Netherlands, the normal withholding regime was applicable, which meant that tax on the dividends was deducted at source. However, the FIE could obtain a refund of the tax deducted in respect of such dividends received. With regard to dividends received from companies established in other States, from which tax had been deducted by those States, the foreign tax could be set off against Dutch corporation tax only up to the amount of Dutch corporation tax proportionately attributable to the dividends in question. As FIEs were taxed at a rate of 0%, no corporation tax was attributable to inbound dividends. Consequently, it was impossible for the foreign tax levied on those dividends to be credited.

Furthermore, a special scheme applied to FIEs in order to make the tax burden on their investment proceeds the same as that on direct investments by private investors, by establishing a system of concessions designed to take account of foreign tax deducted from dividends issued to those enterprises. These concessions were subject to two limits. First, the concession could not exceed the amount of relief to which a shareholder resident in the Netherlands would be entitled under a tax treaty in the event of direct investment. Secondly, the amount of relief depended on the number of non-resident shareholders in the FIE. The ECJ only considered the first limit as an issue concerning inbound dividends. Since the second limit distinguished on the basis of the place of residence of the FIE's shareholders, the ECJ analysed it as an issue concerning outbound dividends (see 2.E.I.A.b.6.c.4).

In the situation at hand, the FIE (hereafter: 'OESF') received German- and Portuguese-sourced dividends. The tax treaty between Germany and the Netherlands made no provision for a right to set off German tax deducted from German-sourced dividends paid to a Dutch resident. Moreover, no tax treaty was in force between Portugal and the Netherlands at the material time. Upon receiving German- and Portuguese-sourced dividends, OESF was taxed in Germany and Portugal by way of deduction at source. Pursuant to the provisions of the Dutch regime described above, OESF was not entitled to the concessions with respect to those dividends. In the case at hand, the effect of that regime was that tax on dividends deducted at source in Germany and Portugal was not taken into account in the calculation of the concession because, at the material time, the tax treaty between Germany and the Netherlands made no provision for a right to set off tax deducted in Germany against Dutch income tax and because no tax treaty had been concluded between Portugal and the Netherlands. By contrast, a Dutch FIE that received dividends from a company established in the Netherlands was entitled to a full refund of the Dutch tax on dividends deducted at source by those companies. According to OESF, this difference in treatment constituted a violation of the free movement of capital.

a. German- and Portuguese-sourced dividends as compared to Dutch-sourced dividends

The ECJ first observed that, as the Netherlands had made FIEs liable to corporation tax, but at a rate of 0%, enterprises such as OESF were not subject to tax on dividends under Dutch law,

[1607] C-194/06, *Staatssecretaris van Financiën v Orange European Smallcap Fund NV*, 20 May 2008. See also H. VAN DEN HURK, G. WEENING, H. VAN DEN BROEK and J. KORVING, "Dutch withholding tax rules as applied to FIIs partially incompatible with EC law", *Intertax* 2008, 410-412.

whatever the origin of the dividends. As regards domestic dividends, the tax initially deducted from those dividends (which constituted an advance payment of corporation tax) was refunded. As regards German- and Portuguese-sourced dividends, no tax was deducted in the Netherlands with respect to such an enterprise. Thus, the ECJ concluded that, by not charging FIEs to tax on dividends from Germany or Portugal, the Netherlands treated those dividends in the same way as dividends from Dutch companies, in respect of which FIEs were not taxed either. In addition, by refraining from taxing dividends from other Member States, the Netherlands avoided the imposition of a series of charges to tax arising from the exercise of its own fiscal power, just as it did in respect of dividends paid by Dutch companies[1608].

The ECJ immediately adds that a disadvantage occurs with respect to the German and Portuguese dividends as compared to domestic dividends, but the Court indicates that the greater tax burden on the former category of dividends is not attributable to the Dutch legislation at issue, but is the result of the parallel exercise of fiscal sovereignty by the Member States in which the distributing companies are established and the Member State in which the recipient company is established, whereby the former chose to impose a series of charges to tax on distributed dividends and the latter opted to refrain from any taxation of dividends with respect to FIEs[1609].

In this respect, the Commission had suggested that it was for the Netherlands, in its capacity as the Member State of residence of the company receiving the dividends, to offset the foreign tax burden on those dividends in the same way as it offsets the domestic tax burden to which those dividends are subject. However, the ECJ disagreed. The Court first repeats its *Lenz/Manninen*-reasoning that where a Member State has a system for preventing or mitigating double taxation for domestic dividends, it must treat inbound dividends in the same way because under such systems, a resident shareholder who receives domestic dividends is comparable to a resident shareholder who receives dividends from a company established in another Member State, since both types of dividends may be subject to double taxation[1610].

The Court then formulates a nuance to this general rule: *"However, the status of Member State of residence of the company in receipt of dividends cannot include the obligation for that Member State to offset a fiscal disadvantage arising where a series of charges to tax is imposed entirely by the Member State in which the company distributing those dividends is established, since the dividends received are neither taxed nor treated differently by the first Member State as regards investment enterprises established in that State"*[1611]. Applied to the situation of OESF: the greater tax burden on German and Portuguese dividends did not arise as a result of a difference in treatment attributable to the tax regime in the Netherlands, but stemmed from the decision of Germany and Portugal to make a deduction at source from

[1608] C-194/06, *Orange European Smallcap Fund*, § 33-35.
[1609] C-194/06, *Orange European Smallcap Fund*, § 37, referring to C-513/04, *Kerckhaert-Morres*, § 20.
[1610] C-194/06, *Orange European Smallcap Fund*, § 39-40.
[1611] C-194/06, *Orange European Smallcap Fund*, § 41. Remarkably, the English version of the judgment differs somewhat from the French version. In the English version, the last part of § 41 reads *"since the dividends received are **neither taxed nor treated differently** by the first Member State as regards investment enterprises established in that State."* Arguably, the French version is more correct: *"dans la mesure où le premier État membre **n'impose ni ne prend en compte de manière différente**, dans le chef des organismes de placement collectif établis sur son territoire, les dividendes perçus."* The English version seems to refer to some form of differential treatment by the State of residence, whereas the French version merely indicates that the State of residence does not tax the income, nor does it take the income into account in any other way. The Dutch version is in line with the French version and reads as follows: *"wanneer de eerstgenoemde lidstaat de ontvangen dividenden **niet belast** bij de op zijn grondgebied gevestigde beleggingsinstellingen **noch anderszins in aanmerking neemt**."*

those dividends, and from the decision of the Netherlands not to tax those dividends. According to the ECJ, *"the fact that the latter Member State has not granted a concession in respect of the deduction at source for which the first two States have opted does not constitute a restriction on the free movement of capital"*[1612].

<u>*b. Commentary*</u>

It is unfortunate that the ECJ does not really address the question of comparability in this aspect of the *Orange European Smallcap*-case. There are three steps in the Court's argumentation. First, the Court states that the Netherlands does not distinguish between German or Portuguese dividends and domestic dividends: whatever the origin of the dividends, FIEs are not subject to tax on them in the Netherlands. That is to say, the tax initially deducted at source from **domestic dividends** is refunded to the FIE, while the Netherlands simply does not tax **foreign dividends** (since the FIE is subject to a 0% tax rate). Consequently, by not taxing FIEs on German or Portuguese dividends, the Netherlands treats those dividends in the same way as domestic dividends. In addition, by refraining from taxing foreign dividends, the Netherlands avoids double taxation arising from the exercise of its own fiscal power, just as it does in respect of domestic dividends (§ 34-36 of the decision).

Secondly, even if, despite the identical treatment by the Netherlands, there is a disadvantage where German or Portuguese dividends are concerned, then that disadvantage is not caused by the Dutch legislation but by the interplay of the different tax systems at issue (§ 37 of the decision). This is in line with *Kerckhaert-Morres*, where the Court held that a Member State cannot be blamed for possible disadvantages arising for foreign dividends if that State does not distinguish (and, thus, does not discriminate) between domestic and foreign dividends (see supra).

Finally, the Court dismisses the argument that it is up to the Netherlands, in its capacity as the recipient's State of residence, to remove double taxation of foreign dividends in the same way as it does with respect to domestic dividends. Since the Netherlands did not tax foreign dividends, the disadvantage was not due to the Dutch system, but due to the interplay between the decision of Germany and Portugal to withhold tax at source and the decision of the Netherlands not to tax foreign dividends (§ 38-42 of the decision).

Accordingly, it does not seem that the Court wanted to amend its *Lenz/Manninen*-doctrine. *Orange European Smallcap* simply does not say anything about the comparability of the situations. The Court's analysis in *Orange European Smallcap* does not concern the comparability of the situations, but the existence of a disadvantage. More specifically, since the shareholder's State of residence (the Netherlands) did not tax the dividend income, one cannot maintain that a disadvantage is caused by that State. If there is a disadvantage, it is due to a disparity and therefore outside the scope of the fundamental freedoms. So the *Lenz/Manninen*-comparability still holds entirely: shareholders receiving domestic dividends and shareholders receiving foreign dividends are still comparable with respect to the residence State's regime for the mitigation or prevention of double taxation[1613]. However, the conclusion drawn therefrom in *Lenz/Manninen* is not upheld where no disadvantage arises in that State. In *Orange European Smallcap*, no disadvantage could be said to arise in the State of residence, as that State did not exercise its taxing power. Given the absence of such a disadvantage, the State of residence was not obliged to credit the foreign tax. Its mere status

[1612] C-194/06, *Orange European Smallcap Fund*, § 42.
[1613] See § 40 of *Orange European Smallcap*, where the basic *Lenz/Manninen*-comparability is confirmed.

as residence State does not entail such an obligation where it does not tax the income, nor take it into account in any other way[1614].

That being said, it should be noted that the Court's analysis starts from the incorrect assumption that the Netherlands did not distinguish between domestic dividends and foreign dividends. Clearly, there was a distinction, since FIEs were entitled to a refund for source tax withheld on domestic dividends but not for source tax withheld on foreign dividends.

In my opinion, however, that difference in treatment is not necessarily discriminatory because FIEs receiving German or Portuguese dividends are not comparable to FIEs receiving domestic dividends. In order to understand why the situations are incomparable, it is necessary to consider the objective of the Dutch measure at issue. As noted above, the Dutch regime sought to assimilate the tax burden on investment proceeds received through an FIE to the tax burden on proceeds from direct investments by individuals. In order to achieve that goal, FIEs were taxed in the Netherlands at a rate of 0% and the tax withheld at source on domestic dividends was refunded to the FIE receiving the dividend. Where the FIE received foreign dividends, the Netherlands restricted the relief for foreign tax to the amount to which a resident individual would be entitled under the tax treaty with the source State. Finally, when dividends were passed on to the shareholders of the FIE, tax was withheld at source by the FIE, irrespective of whether it concerned domestic or foreign dividends.

So unlike the domestic measures at issue in *Lenz* and *Manninen*, the Dutch regime was not simply aimed at avoiding double taxation on dividends. Instead, the regime was intended to ensure tax neutrality between direct investments and investments through an FIE. For domestic dividends, that goal was achieved by refunding the tax withheld by the distributing company. For foreign dividends, the goal was achieved by granting a credit insofar as an individual investing directly would have been entitled to a credit. So in both cases, the objective of tax neutrality is achieved by removing the difference between the tax treatment of a direct investment and the tax treatment of an investment through an FIE.

That distinguishes *Orange European Smallcap* from, for instance, *Manninen*: unlike the Finnish measure at issue in the latter case, the purpose of the Dutch regime at issue in *Orange European Smallcap* was not to take account of the tax paid at the level of the distributing company, but to ensure that the interposition of the fiscal investment enterprise was neutral as regards tax consequences[1615]. From the perspective of that purpose, the relevant characteristic is not simply whether the dividend is susceptible to double taxation, but rather whether there

---

[1614] One could argue that the Court suggests that the source State is to blame for the disadvantage. In § 41 of *Orange European Smallcap*, the ECJ indicates that *"the series of charges to tax is imposed entirely by the Member State in which the company distributing those dividends is established"*. As I have indicated earlier, however, the Court does not seem to consider the mere existence of double taxation to fall foul of EU law. A detailed analysis of the source State's tax legislation, particularly those rules designed to mitigate double taxation, would have to reveal whether the free movement provisions have been respected (see infra, on cases involving outbound dividends).

[1615] See also Opinion of Advocate-General Bot in C-194/06, *Orange European Smallcap*, 3 July 2007, § 90-92: *"The situation in this case is therefore different, in my view, from that at issue in Manninen […]. In Manninen, the Finnish rules granted to persons primarily taxable in Finland a tax credit in respect of dividends paid by companies established in that Member State. The tax credit was intended to prevent the economic double taxation of those dividends. It involved setting off the tax payable in the form of corporation tax by the company distributing the dividends against that payable by the shareholder in the form of income tax. That tax credit differs in two ways from the refund system at issue in the present case. First, […] the purpose of the refund [in Orange European Smallcap] is not to take account of the corporation tax payable by companies established in the Netherlands but to exempt a fiscal investment enterprise from tax on dividends."*

is a difference between the tax treatment of a direct investment and the tax treatment of an investment through an FIE (if there was no concession for the FIE). For a foreign dividend, that is only the case where the individual investing directly would have been entitled to a credit, i.e. where a credit is provided for in a tax treaty. In contrast, if there is no tax treaty or if the applicable tax treaty does not grant a credit to Dutch residents, there is no difference between the tax treatment of a direct investment and the tax treatment of an investment through an FIE. In the case of a direct investment, the source State withholds tax and the shareholder is taxable in the Netherlands without being entitled to a credit there. In the case of an investment through an FIE, the source State withholds tax, the FIE remains untaxed in the Netherlands and the shareholder is taxed on the dividend in the Netherlands (by way of withholding by the FIE) withhout being entitled to a credit there. So it is not necessary to grant a concession in order to achieve neutrality. In contrast, a domestic dividend is subject to tax at source when it is distributed to the FIE, and again when it is distributed to the FIE's shareholder. In order to ensure neutrality, it is necessary to remove that first layer of tax (which the Netherlands regime does by granting a refund to the FIE). Consequently, since the relevant characteristic is different for the subject and object of comparison, the different treatment as regards the granting of a concession does not constitute discrimination.

So ultimately, the Court's conclusion can be approved of but it is unfortunate that the ECJ had little regard for the purpose of the Dutch measure at issue. Finally, it is remarkable that the purpose of the Dutch measure was taken into account extensively in the Court's analysis of the second issue, concerning the influence of tax treaties on the comparability-test (see 2.E.I.A.b.9.c).

c. The influence of tax treaties: German- and Portuguese-sourced dividends as compared to dividends sourced in certain other Member States

After comparing the treatment of the German- and Portuguese-sourced dividends to the treatment of Dutch-sourced dividends, the comparison is made between the treatment of the German- and Portuguese-sourced dividends and the treatment of dividends sourced in certain other Member States. As this issue concerns the influence of tax treaties on the comparability-test, it will be addressed in 2.E.I.A.b.9.c.

7. Test Claimants in the FII Group Litigation[1616]

1. Facts and legal issue

The *FII*-case concerned the U.K. system of advance corporation tax ('ACT'), which was referred to earlier. Because the *FII*-case concerns the inbound aspects of that regime, it is useful to give a brief overview of the legal framework.

Under the tax laws in force in the U.K. at the material time, resident companies were subject to corporation tax on their profits. In order to avoid economic double taxation when such profits were distributed, a system of taxation known as 'partial imputation' was designed, under which part of the corporation tax paid by the distributing company was imputed to its shareholders. The basis of that system was, on the one hand, advance payment of corporation tax by the distributing company, and, on the other hand, a tax credit granted to shareholders who received a dividend.

[1616] ECJ 12 December 2006, C-446/04.

A company resident in the U.K. which **paid** dividends to its shareholders was liable to pay ACT. The ACT paid in respect of a distribution made could be set off against the amount of mainstream corporation tax ('MCT') for which the distributing company was liable in respect of that accounting period, subject to certain restrictions. If the liability of a company for corporation tax was insufficient to allow the ACT to be set off in full, the surplus ACT could be carried back to a previous accounting period or carried forward to a later one, or surrendered to subsidiaries of that company, which could set it off against the amount of corporation tax for which they themselves were liable. Surplus ACT could be surrendered only to resident subsidiaries.

Where a resident company **received** dividends from another resident company, it was not liable to corporation tax in respect of those dividends. Moreover, every payment of dividends subject to ACT by a resident company to another resident company entitled the latter company to a tax credit equal to the ACT paid by the former company. The dividend received and the tax credit together constituted 'franked investment income' ('FII') in the hands of the company receiving the dividends. The recipient could recover the amount of ACT paid by the distributing company and deduct it from the amount of ACT which it had to pay itself when making a distribution to its own shareholders, with the result that it was liable for ACT only on the excess.

The situation of a resident company receiving dividends from a non-resident company was less advantageous. Such a company was liable to corporation tax on the dividends received and was not entitled to a tax credit, nor did the dividends qualify as franked investment income. However, the recipient was entitled to relief for tax paid by the distributing company in the source State. Such relief was granted either under the U.K. legislation or under a tax treaty concluded between the U.K. and the source State. Thus, the national legislation allowed withholding taxes paid on dividends from a non-resident company to be offset against the recipient's liability to corporation tax. Where a resident company receiving dividends either directly or indirectly controlled (or was a subsidiary of a company which directly or indirectly controlled) 10% or more of the voting rights in the distributing company, the relief extended to the underlying foreign corporation tax on the profits out of which the dividends were paid. Relief on that foreign tax was available only to the amount of corporation tax due in the U.K. on the income concerned. Similar provisions applied under the tax treaties concluded by the U.K.

When a resident company itself paid dividends to its own shareholders, it was liable to pay ACT, which it could subsequently set off against its MCT (see supra). However, the fact that such a resident company received dividends from a non-resident company could result in **surplus ACT** for two reasons. First, the payment of dividends by a non-resident company did not give rise to a tax credit which could be deducted from the amount of ACT for which the resident company was liable when it paid dividends to its own shareholders. Secondly, when a resident company was entitled to relief on foreign tax paid by that non-resident company abroad, the offsetting of that tax against the MCT reduced the amount that the resident company might deduct from the ACT for which it was liable.

The taxpayers who initiated the proceedings were U.K. resident companies ('the claimants') forming part of a group. The parent company in the group held, directly or indirectly, 100% of the capital of other companies which themselves held 100% of the capital of companies established in a number of Member States of the EU and the EEA, as well as in third countries. Several questions were referred to the ECJ for a preliminary ruling. The questions which are relevant to the present inquiry will be examined systematically below. Several aspects of these questions are concerned with the disadvantage-test rather than the comparability-test. However, as these different aspects are interdependent, it is advisable to discuss them together.

2. The first question

The first question was whether the U.K. regime infringed the fundamental freedoms by exempting dividends received by a resident company from another resident company from corporation tax and imposing corporation tax on dividends received by a resident company from a non-resident company, while granting relief in the latter case for all withholding tax levied in the source State and (where the recipient held at least 10% of the voting rights in the distributing company) relief for the corporation tax paid by the distributing company on the profits underlying the dividends.

The freedom of establishment

The Court starts by addressing the compatibility with the freedom of establishment, i.e. in situations where the shareholder holds 10% or more of the voting rights in the distributing company and has a definite influence over the decisions of that company and the possibility to determine its activities. As to the existence of a disadvantage for foreign-sourced dividends, the ECJ first observes that Member States wishing to mitigate economic double taxation on dividends may choose between a number of systems which do not necessarily lead to the same result for the shareholder. For instance, under an exemption system, a shareholder who receives a dividend is not liable to tax on the dividends received, irrespective of the rate of tax to which the underlying profits are subject to tax in the hands of the distributing company and the amount of that tax which that company has in fact paid. By contrast, under an imputation system (such as the system at issue in *FII*), a shareholder may offset tax due on the dividends paid only to the extent of the amount of tax which the distributing company has actually paid on the underlying profits, and that amount may be offset only up to the limit of the amount of tax for which the shareholder is liable. In this respect, the ECJ refers to the Parent-Subsidiary Directive, which expressly leaves it open to the Member States to choose between an exemption system and an imputation system.

However, in structuring their tax system and, in particular, when they establish a mechanism for mitigating economic double taxation, Member States must comply with the requirements imposed by the free movement provisions. Thus, referring to *Lenz* and *Manninen*, the Court states that, whatever the mechanism adopted for mitigating economic double taxation, the free movement provisions preclude a Member State from treating foreign-sourced dividends less favourably than domestic dividends, unless the difference in treatment concerns incomparable situations or is justified. Likewise, as regards the option which the Parent-Subisidiary Directive leaves to the Member States, the ECJ has pointed out that this option may be exercised only in compliance with the free movement provisions[1617].

The ECJ then addresses the question whether a Member State may operate an exemption system for domestic dividends when it applies an imputation system to foreign-sourced dividends. The Court states that *"it is for each Member State to organise, in compliance with*

[1617] C-446/04, *FII*, §46, referring to C-471/04, *Keller Holding*, § 45.

Community law, its system for taxing distributed profits and, in particular, to define the tax base and the tax rate which apply to the company making the distribution and/or the shareholder receiving them, in so far as they are liable to tax in that Member State." Thus, the fundamental freedoms do not, in principle, prohibit a Member State from preventing economic double taxation on domestic dividends by applying an exemption system and on foreign-sourced dividends by applying an imputation system. As to the core of the disadvantage-test, the Court holds that, in such a situation, two conditions must be met in order to ensure compliance with the fundamental freedoms: first of all, the foreign-sourced dividends must not be subject to a higher rate of tax than the rate which applies to domestic dividends and economic double taxation on foreign-sourced dividends must be prevented by offsetting the amount of tax paid by the non-resident distributing company against the amount of tax for which the recipient company is liable, up to the limit of the latter amount.

As to the latter condition, the Court discerns two possible situations. First, when the profits underlying the foreign-sourced dividends are subject to a lower level of tax in the source State than the tax levied in the recipient's State of residence, the latter Member State must grant an overall tax credit corresponding to the tax paid by the distributing company in the source State. Where, conversely, those profits are subject in the source State to a higher level of tax than the tax levied by the recipient's State of residence, the latter Member State is obliged to grant a tax credit only up to the limit of the amount of corporation tax for which the recipient company is liable. It is not required to repay the difference, that is to say, the amount paid in the source State which is greater than the amount of tax payable in the State of residence.

If those conditions are met, it is not problematic, according to the Court, that an imputation system imposes additional administrative burdens on the taxpayer (i.e. the requirement of evidence as to the amount of tax actually paid in the source State). The Court holds that such additional administrative burdens *"cannot be regarded as a difference in treatment which is contrary to freedom of establishment, since particular administrative burdens imposed on resident companies receiving foreign-sourced dividends are an intrinsic part of the operation of a tax credit system"*[1618]. This point will be addressed in more detail in 2.E.I.B.b.1.

Put briefly, the Court (implicitly) applies the *Lenz/Manninen*-comparability. As the situations are comparable, the cross-border situation must not be treated less favourably. This issue, i.e. the existence of a disadvantage, is at the heart of the debate in the first part of the Court's reasoning in *FII*. More specifically, the application of an exemption system to domestic dividends and an imputation system to foreign-sourced dividends does not automatically fall foul of the freedom of establishment, provided that foreign-sourced dividends are not treated less favourably. This proviso consists of two obligations. First, the foreign-sourced dividends must not be subject to a higher rate of tax than domestic dividends. Secondly, the amount of tax paid by the non-resident distributing company must be offset against the amount of tax for which the recipient company is liable, up to the limit of the latter amount.

The free movement of capital

For resident companies receiving dividends from companies in which they hold fewer than 10% of the voting rights, domestic dividends are exempt from corporation tax, while foreign-sourced dividends are subject to that tax and are entitled to relief only as regards the

[1618] C-446/04, *FII*, § 53.

withholding tax charged on those dividends in the source State[1619]. In this respect, the ECJ first repeats the *Lenz/Manninen*-comparability: in the context of a tax rule which seeks to mitigate double taxation of distributed profits, the situation of a resident receiving foreign-sourced dividends is comparable to that of a resident receiving domestic dividends in so far as the profits are susceptible to double taxation in both cases.

Because the situations are comparable, the question arises whether foreign-sourced dividends incur a disadvantage. In this respect, the Court observes that the U.K. exemption system eliminates the risk of double taxation of the profits where domestic dividends are concerned. However, the U.K. does not eliminate that risk with respect to foreign-sourced dividends: the relief granted in the U.K. for withholding tax levied in the source State does no more than eliminate double juridical taxation in the hands of the company receiving the dividends. But that relief does not eliminate the (economic) double taxation which arises when the distributed profits are subject first to corporation tax in the distributing company's State of residence and then to corporation tax in the recipient's State of residence. Such a difference in treatment discourages U.K. residents from investing in non-resident companies and non-resident companies from raising capital in the U.K.[1620] The Court therefore concludes that the U.K. regime infringed the free movement of capital.

3. The second question

The second question concerned the fact that a resident company receiving dividends from another resident company was entitled to a tax credit equal to the ACT paid by the latter in respect of the distribution. When the recipient subsequently paid dividends to its own shareholders, it could offset the ACT paid upon the first distribution against the ACT due on the second distribution. In contrast, a resident company which has received dividends from a non-resident company had to pay the ACT in full upon making a distribution to its own shareholders[1621].

The Court first observes that this different treatment causes a cash-flow disadvantage. The effect of the U.K. measure is that a resident company which has received foreign-sourced

---

[1619] Resident companies receiving dividends from a company in which they hold 10% or more of the voting rights, without that holding conferring on them a definite influence over the decisions of that company or allowing them to determine its activities (i.e. in which case the free movement of capital applies), are also subject to the regime described above. Consequently, the ECJ repeats its decision reached under the freedom of establishment: the U.K. legislation does not give rise to discriminatory treatment (C-446/04, *FII*, § 58-60).

[1620] C-446/04, *FII*, § 61-64, referring to *Verkooijen*, *Lenz* and *Manninen*. Unsurprisingly, the ECJ dismisses the U.K. government's justification argument on the basis of administrative difficulties that may arise in determining the tax actually paid in the source State (C-446/04, *FII*, § 70). Furthermore, the fact that the U.K. measure was more generous than the Parent-Subsidiary Directive (i.e. because the U.K. granted relief for corporation tax paid in the source State for participations exceeding 10%, while the Directive only required this for participations exceeding 25%) did not affect the ECJ's conclusion. The fact that the Directive did not require the U.K. to grant such relief in situations where the participation did not exceed 25% did not mean that the U.K. could freely discriminate in those situations. Insofar as domestic dividends were entitled to relief for corporation tax paid at the level of the distributing company, that relief should also be granted to foreign-sourced dividends. In other words, the Directive sets an absolute standard, while the fundamental freedoms set a relative standard. As soon as the Directive applies (i.e. participations exceeding 25%), relief must be granted to foreign-sourced dividends. But even if the Directive does not apply, the fundamental freedoms require that relief must be granted to foreign-sourced dividends **insofar as** it is also granted to domestic dividends. If domestic dividends are not entitled to relief either, it is permitted to deny such relief to foreign-sourced dividends not covered by the Directive (C-446/04, *FII*, § 66-69).

[1621] This distinction was also tested against the Parent-Subsidiary Directive but, given the scope of the present study, that issue will not be addressed here.

dividends and pays dividends of the same amount to its own shareholders must pay ACT in full, whereas a resident company which has received domestic dividends and pays dividends to its own shareholders of the same amount has the benefit of the tax credit and is thus no longer obliged to pay ACT. In the latter case, the fact of not having to pay ACT thus represents a cash-flow advantage for the recipient, in so far as the company concerned may retain the sums which it would otherwise have had to pay by way of ACT until corporation tax is payable[1622].

The U.K. government then argued that no discrimination arose because the situations could not be compared. More specifically, the different treatment was not based on a distinction between domestic dividends and foreign-sourced dividends, but between dividends on which ACT has been paid and those on which no ACT has been paid. The tax credit granted to a resident company receiving dividends from another resident company was designed to prevent economic double taxation **in the field of ACT**. Since, in the case of a company receiving dividends from a non-resident company, no ACT has been paid by the latter, the U.K. government held that there was no risk of economic double taxation as regards ACT[1623]. As the relevant characteristic of the *Lenz/Manninen*-comparability (i.e. the susceptibility to double taxation) would thus be different among both situations, the comparability could not be maintained.

The ECJ dismisses that argument. The Court points out that ACT is nothing more than an advance payment of corporation tax, even though it is levied in advance when dividends are paid and calculated by reference to the amount of those dividends. The ACT which is paid when a company distributes dividends can be set off against the corporation tax which that company must pay on its profits for the corresponding accounting period[1624].

Non-resident companies are not obliged to pay ACT upon paying dividends to a resident company because their seat is outside the U.K. However, they are also liable to corporation tax in their State of residence. As a result, the fact that a non-resident company has not been required to pay ACT when paying dividends to a resident company does not render the resident recipient incomparable to a resident company receiving dividends from another resident company. The reason why a non-resident distributing company is not liable to ACT is that it is not subject to corporation tax in the U.K., but in its State of residence. As it did in *Metallgesellschaft*, the Court thus concludes that a company cannot be required to pay in advance a tax to which it will never be liable.

Put briefly, resident companies receiving domestic dividends are comparable to resident companies receiving foreign-sourced dividends, as both resident distributing companies and non-resident distributing companies are subject to corporation tax in their State of residence. Consequently, a national measure which is designed to avoid double taxation of distributed profits only as regards domestic dividends, while exposing companies receiving foreign-sourced dividends to a cash-flow disadvantage, constitutes discrimination[1625].

[1622] C-446/04, *FII*, § 82-84, referring to Joined Cases C-397/98 and C-410/98, *Metallgesellschaft*.
[1623] C-446/04, *FII*, § 85.
[1624] See also supra, 2.E.I.A.b.5.a, on *Metallgesellschaft*, where the Court relied the same argument when considering the position of a resident company **paying** dividends.
[1625] C-446/04, *FII*, § 86-91. To some extent, the disadvantage in question was attenuated by the introduction of the 'FID' regime in the U.K. in 1994. From then on, a resident company receiving foreign dividends could elect that a dividend which it paid to its shareholders was treated as a 'foreign income dividend' ('FID'). ACT was payable on the FID but, to the extent to which the FID matched the foreign dividends received, the resident company could claim repayment of the surplus ACT. While ACT was payable within 14 days of the end of the

8. Conclusion: the ECJ's position on inbound dividends

In cases involving inbound dividends, the comparison is between two residents. As a result, the starting point is that the situations are comparable (see supra). The obvious argument would then be that residents receiving foreign-sourced dividends are not comparable to residents receiving domestic dividends because the distributing company in the former case is not subject to tax liability in the recipient's State of residence. However, the ECJ has consistently dismissed that argument by relying on the *Lenz/Manninen*-comparability: in relation to a rule designed to mitigate double taxation of dividends, the situation of residents receiving domestic dividends is comparable to that of residents receiving dividends sourced in another Member State since both types of dividends are susceptible to double taxation.

This line of reasoning has been criticized because it implies that comparability is determined on the basis of a Member State's legislative aims (more specifically, the intention to avoid double taxation). It has been argued that the objective which determines comparability should instead be inherent in the fundamental freedoms, that is, the establishment of an internal market that allows for undistorted competition between market agents (unless such distortions arise from disparities). From that perspective, the comparability as regards inbound dividends should be assessed by verifying whether there is a certain degree of substitutability between the cross-border transaction at issue (i.e. an inbound dividend payment) and similar, purely internal transactions (i.e. a domestic dividend payment). Under such an analysis, inbound dividends will always be comparable to domestic dividends since an investment in a foreign company will always be an economically viable alternative to a similar investment in a domestic company[1626].

While it is true that considerations relating to the intention of the national legislator play an important part in the justification-test, it is nevertheless essential that the intention of mitigating double taxation is also taken into consideration in the comparability-test. In particular, it should be recalled that the Member States remain free to decide whether or not to mitigate double taxation. As mentioned earlier, the existence of double taxation as such cannot be said to infringe the Treaty freedoms. However, when Member States decide to enact legislation that is intended to mitigate double taxation, they are bound by the prohibition of discrimination. That means that inbound dividends should not be treated less favourably than domestic dividends when they are comparable. And in order to determine whether they are comparable, the Court takes account of their susceptibility to double taxation.

That does not mean that comparability is determined entirely by the national legislator's intention. First, it is possible that a national measure that alleviates double taxation also serves

quarter in which the dividend was paid, surplus ACT was repayable when the resident company became liable for MCT, nine months after the end of the accounting period. In *FII*, the ECJ was also asked whether the FID regime was compatible with the free movement provisions, in particular because that regime obliged the resident company to first pay the ACT and to reclaim it subsequently. The ECJ held that a company receiving foreign-sourced dividends is comparable to a company receiving domestic dividends because both types of profits are subject to corporation tax in the source State. Because there are several months between the moment that ACT has to be paid and the repayment of surplus ACT, resident companies electing to be taxed under the FID regime are exposed to a cash-flow disadvantage which does not arise in the case of resident companies receiving domestic dividends. Consequently, the FID regime was incompatible with the fundamental freedoms (C-446/04, *FII*, § 140-173). Questions three and five to nine of the *FII* case will not be addressed here because they are less relevant to the present study.

[1626] J. ENGLISCH, "Taxation of cross-border dividends and EC fundamental freedoms", *Intertax* 2010, 203.

different objectives[1627]. Secondly and more importantly, the prevention of double taxation is not only the legislator's objective when enacting national legislation, it is also an important objective to be realised in the context of the internal market. When a Member State decides to remove the obstacle of double taxation as regards domestic dividends, the principle of non-discrimination inherent in the internal market requires this benefit to be extended to dividends sourced in other Member States. Thus, what is at stake is that both domestic and inbound dividends face the same obstacle, i.e. the possibility of double taxation. Accordingly, when a Member State enacts legislation that alleviates such double taxation, it is obvious that resident recipients of inbound dividends are comparable to resident recipients of domestic dividends. Clearly, the relevant characteristic in the context of such a measure is the susceptibility to double taxation: the decisive issue is that both types of dividends attract a burden which may hamper economic development of the internal market. If a Member State introduces a measure that removes this burden, it is clear that both types of dividends should be entitled to that measure since there is nothing relevant to distinguish them.

It is difficult to imagine another characteristic that could determine their comparability. The mere substitutability from the perspective of the resident investor (see supra) does not seem to be a viable alternative since it does not add anything substantial to the characteristic relied on by the Court. Indeed, the comparability-test should take place against the backdrop of the national measure at issue, and the only characteristic that is relevant in that context is the susceptibility to double taxation. From the perspective of the internal market, the decisive question is whether both situations face the same obstacles to free movement. Obviously, an investor takes these obstacles into account when deciding where to invest, but it would be incorrect to only take the investor's perspective when deciding whether the situations are comparable.

c. Outbound dividends: the exercise of taxing jurisdiction by the source State

1. Test Claimants in Class IV of the ACT Group Litigation[1628]

The starting point of the analysis of the ECJ's case law dealing with outbound dividends is the *ACT*-case. Basically, this body of case law is concerned with situations where a tax advantage is granted in respect of dividends paid by a company resident in State A to a shareholder resident in State A, while this tax advantage is refused in respect of dividends paid by a company resident in State A to a shareholder resident in State B.

At issue in the *ACT*-case was the U.K. legislation on advance corporation tax. The inbound-aspects of this regime were discussed earlier, in the context of *FII Group Litigation* (which was decided on the same day as the *ACT*-case). The *ACT*-case concerns the outbound-aspects of the U.K. regime. Because the domestic legal framework in both cases is very similar, the description of the legal framework will be limited here to the aspects that are relevant for the *ACT*-case.

[1627] For instance, it could be argued that the imputation systems at issue in *Manninen* and *Meilicke* mainly served to ensure that dividend income was ultimately taxed in the same way as other types of income, which implies that the overall domestic tax burden on dividends should be correspond to the shareholder's individual income tax rate.
[1628] ECJ 12 December 2006, C-374/04.

At issue in the *ACT*-case was the tax credit granted to certain shareholders if the ACT had been paid. As noted above, a U.K. resident company that received dividends from another U.K. resident company was not liable to corporation tax in respect of those dividends and it was entitled to a tax credit equal to the ACT paid by the distributing company. The dividend received and the tax credit together constituted 'franked investment income' ('FII') in the hands of the company receiving the dividends. Dividend-receiving resident companies which were entitled to the tax credit, could recover the amount of ACT paid by the distributing company and deduct it from the amount of ACT which they had to pay themselves when making a distribution to their own shareholders, with the result that it was liable for ACT only on the excess.

Individual shareholders resident in the U.K. were liable to income tax on dividends received from a resident company. However, those shareholders were entitled to a tax credit equal to the ACT paid by the distributing company. The tax credit could be deducted from the amount owed by that shareholder by way of income tax on the dividend, or could be paid to that person in cash if the amount of the tax credit exceeded the amount of his tax liability.

The effect of those provisions was that profits distributed by resident companies were taxed once at company level and were taxed at the level of the ultimate shareholder only to the extent that the latter's income tax exceeded the amount of the tax credit to which he was entitled.

The situation of non-resident shareholders was less favourable. A non-resident company was, in principle, subject to tax in the U.K. on its income only in respect of revenue which had its source in the U.K., including dividends received from a U.K. resident company. However, the domestic tax legislation in the U.K. provided that non-resident companies who were not entitled to a tax credit in the U.K. were not liable to tax on those dividends. By contrast, where a non-resident company was entitled in the U.K. to a full or partial tax credit by virtue of a tax treaty, it was liable to income tax in the U.K. on the dividends which it received from a resident company.

Likewise, an individual who was not resident in the U.K. was, in principle, liable to income tax there on dividends deriving from a U.K. source but, in so far as that individual was not entitled in the U.K. to a tax credit under national legislation or a tax treaty, he was not liable to income tax on those dividends in the U.K.

In most tax treaties, the U.K. retained the right to tax the dividends paid by its residents to non-residents, but usually those treaties contained restrictions on the rate of tax which the U.K. could charge. The maximum rate varied depending on the circumstances and, in particular, according to whether the shareholder was entitled to a full or partial tax credit under the tax treaty. Some tax treaties concluded by the U.K. did not confer entitlement to a tax credit on companies resident in the other contracting State when those companies received U.K.-sourced dividends. That was the case, in particular, with the treaties concluded with Germany and with Japan.

Other tax treaties provided for a tax credit in certain circumstances. For example, the tax credit provided for under the treaty concluded with the Netherlands was granted in full to shareholders resident in the Netherlands who controlled fewer than 10% of the voting rights in the distributing company and in part when shareholders controlled 10% or more of the voting rights. That treaty also contained a limitation of benefits provision according to which no entitlement to the tax credit under the treaty arose if the non-resident shareholder was itself owned by a company established in a State with which the U.K. had concluded a treaty which did not provide entitlement to a tax credit to companies receiving U.K.-sourced dividends.

The facts in the *ACT*-case concerned the refusal of the U.K. tax administration to grant a tax credit to non-resident companies receiving dividends from a resident company. The national court selected four test cases involving such non-resident companies for the purpose of the reference for a preliminary ruling. The dividend-receiving companies in those cases were companies resident in Italy, France and the Netherlands.

The Italian resident company held a minority shareholding of at least 10% in the U.K. resident company, while the other cases concerned French and Dutch resident parent companies having 100% control over the U.K. resident company. In the cases of the two parent companies resident in the Netherlands, the first was wholly owned by a company resident in Germany, while the second was owned by a company resident in Japan.

1. The denial of the tax credit in outbound-situations

a. The Court's position

The first question to be addressed by the ECJ concerned the denial of the tax credit when dividends were paid by a resident company to a non-resident shareholder. The ECJ considered this to be an issue of discrimination between, on the one hand, a resident company which is entitled to a tax credit when it receives dividends from another resident company and whose ultimate resident shareholders are also entitled to a tax credit when they are paid dividends and, on the other hand, a non-resident company which is not entitled in the U.K. to a tax credit when it receives dividends from a resident company and whose ultimate shareholders, whether or not resident, are also not entitled to a tax credit. While a resident company receiving dividends from another resident company is entitled to a tax credit equal to the amount of ACT paid by the latter, a non-resident company receiving such dividends is entitled to a tax credit only where provided for under the applicable tax treaty.

Unsurprisingly, the bulk of the discussion centered around the comparability-test. The U.K. government argued that the situations were incomparable because non-resident shareholders were not liable to tax in the U.K. on those dividends and because a non-resident company is also not liable to ACT when it distributes profits to its own shareholders[1629].

Starting point: incomparability

The ECJ noted, first of all, that dividends paid by a company to its shareholders may be subject to economic double taxation in two instances: (a) the dividends are taxed, first, at the level of the distributing company as realised profits and are then subject to corporation tax at the level of the parent company receiving the dividends and (b) the dividends are taxed, first, at the level of the distributing company and are then subject to income tax at the level of the ultimate shareholder. It should be pointed out from the outset that this is quite comparable to the reason given for comparability in *Lenz/Manninen*[1630]. The relationship between both situations will be addressed in depth at a later stage.

[1629] C-374/04, *ACT*, § 47.
[1630] See supra: "*In relation to a tax rule designed to mitigate the effects of double taxation of the distributed profits of a company, the situation residents of a Member State receiving dividends from a company established in that State is comparable to that of residents of that State receiving dividends from a company established in*

The Court then addresses the comparability-issue. Interestingly, it starts doing so by distinguishing the case at hand from the *Lenz/Manninen*-line of cases. After paraphrasing the *Lenz/Manninen*-comparability, the Court observes that the comparability-issue in outbound-situations is different: "*although the situation of those shareholders must be treated as being comparable*[1631] *as regards the application to them of the tax legislation of the Member State in which they are resident, the same is not necessarily true, as regards the application of the tax legislation of the Member State in which the company making the distribution is resident, of the situations in which shareholders receiving dividends resident in that Member State and shareholders receiving dividends resident in another Member State are placed*"[1632].

It is important to note that in *ACT* the comparison is made between shareholders receiving dividends from a company established in their State of residence and shareholders receiving dividends from a company established in another Member State. In other words, the comparison is made between a shareholder resident in State A who receives a dividend from a company established in State A and a shareholder resident in State B who receives a dividend from a company established in State A (see Figure 2). In contrast, the comparison in *Lenz/Manninen* was made between two residents of State A, one of whom received a dividend from a State A-company while the other received a dividend from a State B-company (see Figure 1). Additionally, the two comparisons are made against different backdrops. In *ACT*, the comparison is made in the light of the tax legislation of the Member State in which the distributing company is resident, whereas the relevant backdrop in *Lenz/Manninen* was the tax legislation of the shareholders' State of residence. In the latter case, the situations were found to be comparable because they were both susceptible to double taxation. In *ACT*, however, the Court decides that the situations are not comparable.

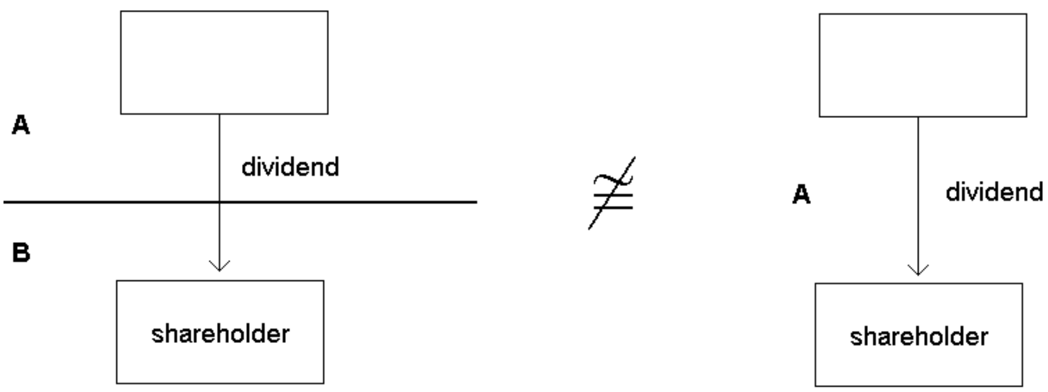


Figure 2: the ACT-incomparability

The Court gives the following reason for this incomparability: "*where the company making the distribution and the shareholder to whom it is paid are not resident in the same Member State, the Member State in which the company making the distribution is resident, that is to say the Member State in which the profits are derived, is not in the same position, as regards*

another Member State, inasmuch as both the dividends deriving from a national source and those deriving from a foreign source may be subject to a series of charges to tax."

[1631] That is to say, in the *Lenz/Manninen*-situation resident shareholders in receipt of inbound dividends are comparable to resident shareholders in receipt of domestic dividends.

[1632] C-374/04, *ACT*, § 55-57.

the prevention or mitigation of a series of charges to tax and of economic double taxation, as the Member State in which the shareholder receiving the distribution is resident"[1633].

This line of reasoning is peculiar. In order to demonstrate that a shareholder resident in State B is not comparable to a shareholder resident in State A, the Court argues that State A and State B are not comparable. This might seem to differ from the actual comparison that needed be made. What was at stake was the comparability between a shareholder who is a resident of the same State as the distributing company and a shareholder who is a resident of another Member State. Transposed to the level of the Member States involved, the comparison should therefore be made between a Member State of which both the shareholder and the distributing company are residents and a Member State of which only the shareholder is a resident.

In effect, however, that is what the Court's analysis boils down to. As will become apparent below, the Court examines whether the Member State in which the distributing company is resident (i.e. the Member State in which the profits are derived) is comparable to the Member State in which the shareholder is resident, i.e. whether a Member State which acts **only** as a source State is comparable to a Member State which acts **both** as a source State and a State of residence. According to the Court, those situations are not comparable.

In order to support this position, the ECJ relies on three arguments[1634]. First, the Court holds that to require the distributing company's Member State of residence to ensure that profits distributed to a non-resident shareholder are not liable to double taxation, either by exempting those profits from tax at the level of the distributing company or by granting the shareholder a tax advantage equal to the tax paid on those profits by that company, *"would mean in point of fact that that State would be obliged to abandon its right to tax a profit generated through an economic activity undertaken on its territory"*.

Secondly, the Court refers to *Schumacker* and points out that, as regards a procedure for preventing or mitigating economic double taxation by the grant of a tax advantage to the ultimate shareholder, it is usually the shareholder's Member State of residence that is best placed to determine the shareholder's ability to pay tax.

Finally, the ECJ refers to Art. 4(1) of the Parent Subsidiary-Directive, according to which the obligation to avoid double taxation is imposed on the State of residence of the parent company, not on the State of residence of the subsidiary.

Thus, the backdrop against which the comparison is made, is the prevention or mitigation of economic double taxation. This is remarkably similar to the reason given for comparability in *Lenz/Manninen*, i.e. the susceptibility to double taxation. As pointed out above, however, the comparison in *ACT* is made in the light of the tax legislation of the distributing company's Member State of residence, whereas the relevant backdrop in *Lenz/Manninen* was the tax legislation of the shareholders' State of residence. Moreover, that aspect of comparability is now shifted to the level of the Member States involved, i.e. the question as to whose responsibility it is to avoid such double taxation. The Court gives three reasons why that responsibility rests on the shareholder's State of residence. First, if it were up to the State of residence of the distributing company (the source State) to avoid double taxation, then that State would lose its right to tax a profit generated through an economic activity undertaken on its territory. Secondly, according the *Schumacker*-reasoning, the shareholder's State of

[1633] C-374/04, *ACT*, § 58.
[1634] C-374/04, *ACT*, § 59-60.

residence is best placed to determine his ability to pay. Finally, the Parent Subisidiary-Directive also requires the shareholder's State of residence to prevent double taxation.

Before applying this analysis to the U.K. legislation at issue, the Court paraphrases the extent of the disadvantage. According to the ECJ, no different treatment occurs between resident companies receiving dividends from another resident company and non-resident companies receiving such dividends, in that neither situation gives rise to taxation in the U.K. The actual difference in treatment occurs between resident companies receiving dividends and non-resident companies receiving dividends, **as regards the ability of those companies to pay dividends to their ultimate shareholders**. In particular, only resident companies are able to pay dividends to their ultimate shareholders which entitle those shareholders to a tax credit equal to the fraction of the corporation tax paid by the company which made the distributed profits.

However, the Court decides that that difference in treatment is not discriminatory, since the situations of the Member States involved are not comparable. In particular, when a resident company pays dividends to its resident ultimate shareholders and the Member State in question grants to such shareholders a tax credit equal to the ACT paid by the distributing company, it does so **in its capacity as the shareholder's State of residence**. With respect to the application of procedures intended to mitigate double taxation, the position of a Member State in which **both** the distributing company and the ultimate shareholder are resident is not comparable to that of the Member State of residence of a company which pays dividends to a non-resident company, which in turn pays them to its ultimate shareholders. The reason for the incomparability is that the latter State acts **only** as the State in which the distributed profits are derived (i.e. the source State).

In other words, the comparison made by the Court is between a Member State which acts **only** as the source State and a Member State which acts **both** as the source State and the shareholder's State of residence. Because of their respective capacities as source State and State of residence, the situations are not comparable[1635].

First nuance: the ultimate shareholder is resident in the distributing company's State of residence

That implies that the situation at issue in *ACT* (Figure 2) should be distinguished from the situation where the recipient of the dividends passes them on to an ultimate shareholder who is resident in the same State as the company that made the distributed profits. In the latter case, the distributing company's State of residence acts **both** as source State of the income and as residence State of the shareholder. That situation is described in Figure 3:

[1635] C-374/04, *ACT*, § 63-65.

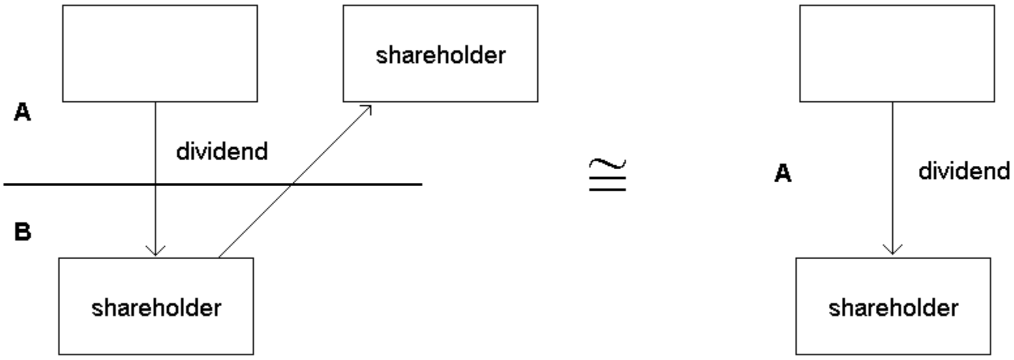


Figure 3: first nuance to the ACT-incomparability

In this scenario, a company resident in State A pays dividends to a company resident in State B and the shareholder of the latter company is a resident of State A. In other words, State A acts **both** as the source State of the dividends and the residence State of the ultimate shareholders. In respect of this scenario, the Court holds that the *Lenz/Manninen*-comparability applies: "*the State in which those [ultimate] shareholders are resident, is obliged, in accordance with the principle laid down in Lenz and Manninen […], to ensure that dividends received by those shareholders from a non-resident company are subject to the same tax treatment as that which applies to dividends received by a resident shareholder from a resident company*"[1636].

Second nuance: the source State taxes the distribution

Moreover, there is also comparability in the *ACT*-situation (see Figure 2) when a Member State, "*unilaterally or by a convention, imposes a charge to income tax not only on resident shareholders but also on non-resident shareholders in respect of dividends which they receive from a resident company*"[1637]. According to the Court, the imposition of such a tax renders the position of the non-resident shareholders comparable to that of resident shareholders[1638].

If the distributing company's State of residence decides to exercise its taxing powers not only in relation to profits made in that State but also in relation to dividends distributed to non-residents[1639], "*it is solely because of the exercise by that State of its taxing powers that, irrespective of any taxation in another Member State, a risk of a series of charges to tax may arise*". In such a case, non-resident companies receiving dividends are being discriminated against (given the comparability and the existence of a disadvantage). Therefore, in order to comply with the freedom of establishment, the State in which the distributing company is

[1636] C-374/04, *ACT*, § 66.
[1637] C-374/04, *ACT*, § 68. Confirmed in, e.g., C-540/07, *Commission v Italy*, 19 November 2009, § 51-54. See also C-170/05, *Denkavit*; C-379/05, *Amurta* and C-194/06, *Orange European Smallcap*, discussed hereafter.
[1638] This has been referred to as the ECJ's 'approximation theory' (e.g. J. ENGLISCH, "Taxation of cross-border dividends and EC fundamental freedoms", *Intertax* 2010, 213). In the English version of the judgment, the Court holds that *"the position of those non-resident shareholders **becomes comparable** to that of resident shareholders"* (emphasis added) once a Member State taxes not only the latter but also the former category of shareholders in respect of dividends received from a resident company. In the French version, this is worded as follows: "*la situation desdits actionnaires non-résidents **se rapproche** de celle des actionnaires résidents*" (emphasis added).
[1639] As regards the facts at issue in the *ACT*-case, that was the case when a tax treaty concluded by the U.K. provided that a shareholder company which is resident in the other contracting Member State is entitled to a tax credit for dividends which it receives from a U.K. resident company (see supra).

resident *"is obliged to ensure that, under the procedures laid down by its national law in order to prevent or mitigate a series of liabilities to tax, non-resident shareholder companies are subject to the same treatment as resident shareholder companies"*[1640].

b. Commentary

The Court's position thus implies that there is no comparability (and, therefore, no discrimination) where the tax laws of a Member State grant a tax credit in respect of dividends paid by a resident company only to resident recipient companies and extend the benefit of that tax credit exclusively to resident ultimate shareholders. Yet, there are two exceptions to this rule, i.e. two cases where the situations are comparable. First, the situations are comparable if the ultimate shareholders are residents of the State where the distributing company is established. Secondly, the situations are also comparable if the State of residence of the distributing company taxes not only resident shareholders but also non-resident shareholders in respect of dividends which they receive from a resident company.

The Court's line of reasoning is not entirely convincing. While the starting position that resident and non-resident shareholders are incomparable is correct (see infra), the arguments given by the Court to support this position are questionable.

The first of these arguments is that requiring the distributing company's State of residence to prevent the double taxation means that that State would be obliged to abandon its right to tax profits generated through an economic activity undertaken on its territory. While it is true that international tax law generally recognizes the right of the source State of a dividend to tax such profits and the resulting dividend distribution[1641], it is not up to the ECJ to distribute taxing rights between Member States on that basis. The allocation of taxing powers as agreed between States may lead to disadvantages for certain taxpayers, but the ECJ has traditionally (and correctly) declared itself incompetent to rule on such disadvantages because that allocation forms part of the Member States' sovereignty in direct tax matters[1642]. In *Damseaux*, the Court has even expressly refused to grant priority to the source State with respect to the taxation of dividends[1643]. So it is remarkable that the Court seems willing to make a decision on this issue by granting priority to the source State in *ACT*. The fact that *Damseaux* concerned juridical double taxation, while *ACT* concerned economic double taxation does not explain this difference[1644]. It is therefore submitted that issues relating to

[1640] C-374/04, *ACT*, § 70-71.
[1641] E.g. Arts. 7, 10(2) and 23 OECD MC.
[1642] E.g. C-513/04, *Kerckhaert-Morres*, § 21-22 and supra, 2.E.I.A.b.6.b.5.
[1643] C-128/08, *Damseaux*, § 31-34: *"In a situation where both the Member State in which the dividends are paid and the Member State in which the shareholder resides are liable to tax those dividends, to consider that it is necessarily for the Member State of residence to prevent that double taxation* ***would amount to granting a priority with respect to the taxation of that type of income to the Member State in which the dividends are paid****. Even though such an attribution of powers complied, in particular, with the rules of international legal practice as reflected in [Article 23B OECD MC], it is not in dispute that Community law […] does not lay down any general criteria for the attribution of areas of competence between the Member States in relation to the elimination of double taxation within the Community. Consequently, […] the fact that both the Member State in which the dividends are paid and the Member State in which the shareholder resides are liable to tax those dividends* ***does not mean that the Member State of residence is obliged, under Community law, to prevent the disadvantages*** *which could arise from the exercise of competence thus attributed by the two Member States"* (emphasis added).
[1644] J. ENGLISCH, "Taxation of cross-border dividends and EC fundamental freedoms", *Intertax* 2010, 214, who also points out another weakness in this argument: if a Member State has chosen the exemption method in order to prevent double taxation, extending that mechanism to non-resident shareholders would not lead to a loss

source country-entitlement as regards profits generated on that country's territory should not affect the comparability of the situations. Instead, they could be taken into account in the justification ground relating to the 'balanced allocation of taxing powers' between the Member States concerned[1645].

The second argument, that the shareholder's State of residence is best placed to determine his ability to pay, is not very convincing either. It is true that the taxpayer's personal and family circumstances should be taken into account when assessing entitlement to person-related tax benefits and there is also some merit in the argument that those circumstances can best be taken into account in the taxpayer's residence State because an assessment of the taxpayer's overall ability to pay is required[1646], but those considerations have nothing to do with mechanisms intended to avoid double taxation of distributed profits. Avoidance of double taxation concerns the taxation of the distributed profits and does not require an assessment of the shareholder's overall ability to pay. Moreover - and contrary to the Court's suggestion - it is generally the distributing company's State of residence that is best placed to assess the amount of corporation tax borne by the distributed profits.

Finally, the Court's third argument for incomparability is that Art. 4(1) of the Parent-Subsidiary Directive requires the parent company's State of residence to avoid double taxation. Apart from the obvious response that the Parent-Subsidiary Directive did not apply to the facts of the case, it should also be pointed out that Art. 7(2) of the Directive provides that the Directive does not affect the application of domestic provisions designed to eliminate or mitigate economic double taxation of dividends, in particular provisions relating to the payment of tax credits to the recipients of dividends[1647]. Consequently, the Court's reference to the Directive in order to support its argument that the shareholder's State of residence should remedy the double taxation is not very convincing

Therefore, those elements should not have been taken into account in the comparability-analysis. The Court's starting position, that residents and non-residents are in principle incomparable, was correct. As noted earlier, this incomparability is explained by the differences in the ability to pay tax. So if there are no valid reasons for comparability, the conclusion should be that the distinction does not give rise to discrimination. After paraphrasing that starting position, the ECJ should then have addressed the possible exceptions to that rule. And the relevant exception in the case at hand is that, as regards domestic measures designed to avoid double taxation of dividends, a non-resident is comparable to a resident if the dividend is susceptible to double taxation[1648]. There is no reason to distinguish the comparability-analysis in outbound cases from that in inbound cases on the basis of the capacity of the Member States involved. That capacity is irrelevant from

---

of tax revenue as regards the profits generated at the level of the resident distributing company (and would therefore not affect the source State's entitlement to tax those profits). On the other hand, if a Member State has chosen for an imputation system, it has voluntarily surrendered the idea of definitive taxation at the level of the distributing company. As a result, the corporate tax is converted into a mere prepayment of the shareholder's income tax. It would thus be contradictory for that State to claim source country entitlement, since it has admitted itself that taxation of profits at the company level is only interim taxation, to be replaced by the taxation at the shareholder level.

[1645] E.g. C-231/05, *Oy AA*, 18 July 2007, § 55; C-414/06, *Lidl Belgium*, 15 May 2008, § 32-34.

[1646] But see the criticism on the *Schumacker*-doctrine in 2.E.I.A.b.1.c.

[1647] See also J. ENGLISCH, "Taxation of cross-border dividends and EC fundamental freedoms", *Intertax* 2010, 216.

[1648] See also C-11/07, *Eckelkamp*, 11 September 2008, § 62-63; C-270/83, *Avoir fiscal*, 28 January 1986, § 20; C-43/07, *Arens-Sikken*, 11 September 2008, § 57.

the perspective of domestic measures that prevent double taxation of dividends. From the perspective of the internal market, the only relevant characteristic is that both domestic and outbound dividends may face the same obstacle, i.e. double taxation. And even if the States' capacity was a relevant characteristic, it is clearly inherent in the comparative attribute (i.e. the capacity of a Member State as either the home State of the shareholder or that of the distributing company is inherent in the shareholder's place of residence). For that reason, it should be disregarded in the comparability-analysis. Of course, it is possible that this consideration comes up for discussion later, in the context of the justification-analysis (see infra, 2.F.III).

c. The Advocate-General's Opinion

In the comparability-test, the Court takes particular account of the capacity in which the States involved are acting: the comparison was made between a Member State which acts **only** as a source State and a Member State which acts **both** as a source State and a State of residence (cf. supra). This emphasis on the capacity in which the States are acting may be inspired by the Advocate-General's Opinion in *ACT*, where a distinction was drawn between obligations imposed on States acting as source State and States acting as State of residence.

According to the Advocate-General, the central obligation imposed on States exercising **home State jurisdiction** is to treat foreign-source income of its residents consistently with the way it has divided its tax base. Insofar as it has divided its tax base to include this foreign-source income (i.e. by treating it as taxable income) it must not discriminate between foreign-source and domestic income[1649]. For instance, insofar as it chooses to relieve economic double taxation on its residents' dividends, a home State, with tax jurisdiction over the worldwide income of its residents, must provide the same relief for inbound foreign-source dividends as for domestic dividends, and must take foreign corporation tax paid into account for this purpose (i.e., the *Lenz/Manninen*-situation). Conversely, if a home State has divided its tax base so that it does not exercise tax jurisdiction over a foreign subsidiary of one of its corporate residents, it is (in principle) consistent for that State to refuse to take into account deductions relating to that foreign-source income in assessing its resident's tax (i.e. the *Marks & Spencer*-situation). As regards individual income tax, the Advocate-General observes that the ECJ's case law has recognised the 'international tax rule' that it is for home States, in accordance with their worldwide tax jurisdiction, to take full account of the personal circumstances of a worker or entrepreneur, unless and to the extent that the source State has taken these into account (e.g. under the provisions of a tax treaty)[1650].

The obligation imposed on **source States** is more limited because such States have tax jurisdiction only over the income that is earned by the non-resident within their jurisdiction. In essence, they are required to treat all non-residents the same as residents, insofar as these non-residents fall within their tax jurisdiction. For instance, tax benefits accorded to resident companies (including those granted pursuant to tax treaties) must be accorded in the same way to PEs of non-resident companies if these PEs are otherwise subject to corporation tax in the same way as resident companies (e.g. *Avoir fiscal*, *Commerzbank*, *Futura*). Moreover, a source State cannot apply thin cap-rules only in respect of outbound interest payments while not applying these rules to domestic payments, unless such a requirement is justified (e.g. *Lankhorst-Hohorst*). As regards individual income tax, this principle means, for example, that

[1649] Advocate-General Geelhoed's Opinion in C- 374/04, *Test Claimants in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue*, 23 February 2006, *ECR* 2006, I-11673, § 58.
[1650] Advocate-General Geelhoed's Opinion in *ACT*, § 60, referring to *De Groot, Gschwind* and *Asscher*.

source States may not distinguish between residents and non-residents in the case of income-related deductions from individual income tax (that is to say, deductions that are 'directly linked' to the activity that generated the taxable income in the source State, e.g. business expenses; see *Gerritse*). In contrast, source States may in principle refuse to grant non-residents person-related benefits granted to residents as, under international tax law, it is for the home State to take personal circumstances into account in individual income taxation (see supra), barring application of the *Schumacker*-principle.

Finally, the Advocate-General observes that, insofar as a source State chooses to relieve domestic economic double taxation for its residents (for example, in taxation of dividends), it must extend this relief to non-residents **to the extent that similar domestic double economic taxation results from the exercise of its tax jurisdiction over these non-residents** (for example, where the source State subjects company profits first to corporation tax and then to income tax upon distribution). This results from the principle discussed above, that the source State should grant the same tax benefits to non-residents as to residents insofar as that State exercises equal tax jurisdiction over both groups[1651].

According to the Advocate-General, the issue in *ACT* did not concern the grant to a resident corporate shareholder of a tax credit equal to the ACT paid by its resident subsidiary (i.e., the first 'level' of economic double taxation relief in the U.K. system). Rather, the issue was whether the individual shareholders of non-resident parent companies should have received the same tax credit as the individual shareholders of resident parent companies (an imputation credit for corporation tax already paid on the dividend, which could be set off against the shareholder's U.K. income tax liability; i.e., the second 'level' of economic double taxation relief in the U.K. system). Consequently, the issue turned on the comparison of resident and non-resident parent companies by reference to the U.K. tax treatment of their individual shareholders[1652].

Interestingly, the eventual conclusion reached by the Advocate-General is not based on the comparability-test, but on his distinction between different types of impediments to the free movement rights. In particular, he argues that the disadvantage (i.e. the greater aggregate tax burden on profits distributed from a U.K. subsidiary via a non-U.K. parent company as compared to profits distributed from a U.K. subsidiary via a U.K. parent company) was not a 'true restriction', but a 'quasi-restriction', *"resulting from disparities and the division of tax jurisdiction between national tax systems."* Therefore, the U.K. tax laws were not discriminatory.

In a purely domestic situation (i.e. where a resident subsidiary distributes profits via a resident parent company to resident individual shareholders), the U.K. exercises home State (worldwide) tax jurisdiction at each of these three stages. In the exercise of this jurisdiction, the U.K. has chosen to relieve double economic taxation on the distribution of subsidiary profits by (a) granting a tax credit to the resident parent company to ensure that ACT is only paid once on these profits and (b) granting an imputation tax credit to the resident shareholder that relieves all or part of his liability to U.K. income tax. In the cross-border situation at issue (where a resident subsidiary distributes profits via a non-resident parent company to an individual shareholder), the U.K. exercised source State (territorial) jurisdiction, meaning that it levied tax only once on the U.K.-sourced profits (namely the ACT levied on the resident subsidiary upon the distribution of profits). The effect of the U.K. system was that outbound

[1651] Advocate-General Geelhoed's Opinion in *ACT*, § 66-69.
[1652] Advocate-General Geelhoed's Opinion in *ACT*, § 75-76.

dividends were not subject to a second level of U.K. taxation in the form of income tax (unless they gave rise to a U.K. tax credit).

The Advocate-General therefore concludes that outbound dividends were treated in precisely the same way as domestic dividends insofar as they came within the U.K.'s tax jurisdiction. In the first place, the payment of each gave rise to ACT liability. In the case of domestic dividends, U.K. income tax was in principle levied in the hands of the shareholder. An imputation credit was granted by the U.K., which extinguished all or part of this income tax liability. In the case of outbound dividends, however, no U.K. income tax was levied (in the absence of a tax treaty providing otherwise). There was therefore no U.K. income tax liability to extinguish with an imputation credit. In conclusion, the extent of the U.K.'s tax jurisdiction over such dividends was jurisdiction to levy ACT, which it exercised in a non-discriminatory manner[1653].

The Advocate-General immediately acknowledges that such U.K.-source profits could be subject to taxation once again in the State of residence of the parent company (double economic taxation) and in the State of residence of the individual shareholder (triple economic taxation). However, *"the rules of taxation priority accepted in international tax law hold that, in principle, the U.K. enjoys taxation priority over U.K.-source profits."* Accordingly, it is open to the State of residence of the parent company to relieve economic double taxation on these U.K.-source profits if it so wishes. In exercising its home State jurisdiction, that State must not discriminate between this foreign-source income and domestic income. Likewise, at the individual shareholder level, it is for the State of residence of the shareholder to relieve, if it so chooses, economic double (or triple) taxation of dividends received (cf. *Manninen*). In exercising this jurisdiction, that State is obliged not to discriminate between foreign- and domestic-source income[1654].

Finally, with respect to the specific situation where the U.K. retained under its tax treaties a right to tax outbound dividends or where the individual shareholder was entitled to a tax credit, the Advocate-General repeats his observations made earlier on the nature of the obligation resting on a source State as regards outbound dividends: insofar as the U.K. exercises tax jurisdiction over non-residents' income, it must treat it the same as residents' income. In other words, to the extent that the U.K. exercises jurisdiction to tax dividends distributed to non-residents, it must ensure that these non-residents receive equivalent treatment – including tax benefits – as residents subject to the same U.K. income tax jurisdiction would receive.

In other words, the Advocate-General reaches the same conclusion as the ECJ, but on the basis of different arguments. While the ECJ finds that the source State should not extend the domestic tax credit to outbound dividends because the situations are not comparable, the Advocate-General holds that the disadvantage is due to a disparity (and, consequently, outside the scope of the Treaty freedoms). In essence, what the Advocate-General is saying, is that the U.K. has not exercised any taxing jurisdiction with respect to the non-resident shareholder, but only with respect to the resident distributing company (in the form of ACT, which may subsequently be set off against MCT). And for that reason, the disadvantage (i.e. the shareholder's non-entitlement to a tax credit) is not due to discrimination but due to a disparity.

[1653] Advocate-General Geelhoed's Opinion in *ACT*, § 80-84.
[1654] Advocate-General Geelhoed's Opinion in *ACT*, § 85-86.

But that argumentation is not entirely accurate. As will be pointed out later (see 2.E.II.A), a disparity occurs when a disadvantage results from the interplay of different domestic tax systems. Because such a disadvantage is the direct result of the Member States' retained sovereignty in direct tax matters, it goes beyond the scope of the fundamental freedoms. Clearly, that is not what happened in *ACT*: the question there was whether it was compatible with the fundamental freedoms for the U.K. to grant a credit to resident shareholders while denying it to non-resident shareholders. So the disadvantage suffered by a non-resident shareholder was not due to the interplay of the U.K. regime with other national tax systems, but due to the U.K.'s refusal to extend the tax credit. Therefore, the decisive question was whether that refusal constitutes discrimination. As held by the Court, it does not. Because the situations are incomparable, it cannot be said that that distinction gives rise to discrimination. On the other hand, the Advocate-General is correct when noting that the conclusion should be different where the U.K. exercises tax jurisdiction with respect to dividends received by non-resident shareholders. Doing so would render the non-resident shareholder comparable to a resident shareholder (see supra), with the result that the tax credit should be extended to the outbound situation.

2. The difference in treatment introduced by the different tax treaties

A second question to be answered by the ECJ in *ACT* concerned the difference in treatment caused by the different tax treaties concluded by the U.K. As a result of the divergent provisions in those tax treaties, companies resident in certain Member States were not entitled to a tax credit in the U.K. when they received U.K.-sourced dividends, while companies resident in other Member States receiving such dividends were granted a (partial) tax credit. Moreover, the question arose whether it was permissible for the U.K. to apply the tax treaty LOB clause described above. Because these questions pertain to the influence of tax treaties on the comparability-test, they will be addressed in 2.E.I.A.b.9.b.

2. Denkavit[1655]

The taxpayer was a Dutch company that received dividends from its two French subsidiaries. The taxpayer held more than 25% of the capital in both French companies. Pursuant to the provisions of French tax law in force at the material time, dividends paid by a resident company to non-resident shareholder were subject to a withholding tax of 25%. In the case of dividends paid by a resident company to a resident shareholder, no withholding tax was levied. Moreover, a parent company having its registered office or a permanent place of business in France was entitled under certain conditions to almost full exemption from corporation tax in respect of dividends paid by its subsidiary. Apart from a 5% share, such dividends did not form part of the net taxable profits of the parent company and were accordingly exempt from tax in its hands. The 5% share continued to form part of the net taxable profits of the parent company and was subject to tax at the rate applicable for corporation tax purposes.

Article 10(1) of the tax treaty between France and the Netherlands provided that dividends paid by a company resident in one Contracting State to a resident of the other State were taxable in the latter State. However, by virtue of Article 10(2) of that treaty, such dividends could be taxed in the State of residence of the distributing company at a maximum rate of 5% if the parent company owned at least 25% of the capital of the subsidiary. Pursuant to Article

[1655] ECJ 14 December 2006, C-170/05, *Denkavit Internationaal BV, Denkavit France SARL v Ministre de l'Économie, des Finances et de l'Industrie*.

24 of the treaty, the Netherlands granted an ordinary credit for dividends received by its residents that were taxable in France under the provisions of the tax treaty.

Applying these provisions, the French tax authorities applied a withholding tax of 5% of the amount of the dividends paid to the Dutch company. The question arose whether the French withholding tax was compatible with the fundamental freedoms[1656] and whether that issue was affected by the Dutch/French tax treaty.

The compatibility of the French withholding tax with the freedom of establishment

The ECJ first observed that non-resident companies receiving French-source dividends incurred a disadvantage as compared to resident companies receiving such dividends: unlike dividends paid to resident parent companies, dividends paid to non-resident parent companies were subject to double taxation in France, as they were subject to tax, first, in the form of corporation tax levied on the distributing resident company and, secondly, in the form of the withholding tax levied on the non-resident parent company receiving the dividends[1657].

The French government first argued that the comparability-test was not met. It argued that the comparison should not be made between non-resident parent companies and resident parent companies, but between non-resident parent companies with a fixed place of business in France and non-resident parent companies without a fixed place of business in France. The (almost full) exemption from tax on dividends was also available to non-resident parent companies with a fixed place of business in France. The French government held that, for the purposes of a withholding tax provision, the situation of non-resident parent companies which do not have a fixed place of business in France is not comparable to that of non-resident parent companies which do have a fixed place of business in France. Moreover, the French Government added that the principle of territoriality would be violated if dividends paid by resident subsidiaries to non-resident parent companies which do not have a fixed place of business in France were exempt from French withholding tax. In such a case, the parent companies would be able to avoid any liability to tax on their income, both in France and their State of residence, which would undermine the allocation of taxing powers between France and the parent company's State of residence.

The ECJ dismissed these arguments. As to the comparability-issue, the Court repeated its *ACT*-reasoning: in the context of domestic measures intended to mitigate double taxation of outbound dividends, resident shareholders receiving dividends are not necessarily comparable to non-resident shareholders receiving dividends, but that changes as soon as that Member State taxes not only resident shareholders but also non-resident shareholders on dividends received from a resident company[1658].

Applied to the facts of the case at hand, the Court thus held that parent companies receiving dividends from resident subsidiaries are comparable as regards the taxation in France of those dividends, whether they receive those dividends as resident parent companies or as non-resident parent companies with a fixed place of business in France, or as non-resident parent companies without a fixed place of business in France. In each of those cases, France imposes a liability to tax on dividends received from a resident company. The exemption in respect of

[1656] As the dispute related to facts which occurred before the adoption of the Parent/Subsidiary-Directive, the case was decided entirely on the basis of the fundamental freedoms.
[1657] C-170/05, *Denkavit*, § 26-29.
[1658] C-170/05, *Denkavit*, § 33-35.

dividends received by resident parent companies was designed to avoid the imposition of double taxation on the profits of subsidiaries which are distributed by way of dividend to their parent companies. Because France has chosen to relieve its residents of such a liability to tax, *"it must extend that relief to non-residents to the extent to which an imposition of that kind on those non-residents results from the exercise of its tax jurisdiction over them"*[1659].

The argument based on territoriality was also dismissed by the Court: the different treatment could not be justified by the need to prevent non-resident companies without a fixed place of business in France from avoiding any liability to tax on French-sourced dividends because resident parent companies are also free of any subsequent liability to tax on those dividends[1660]. As a result, the French measure infringed the freedom of establishment.

In *Denkavit*, the Court thus repeats the comparability-analysis made in *ACT*, with one additional clarification: shifting the comparison from the vertical level (i.e. non-residents as compared to residents) to the horizontal level (i.e. non-residents with a fixed place of business in the source State as compared to non-residents without a fixed place of business in the source State) is to no avail if the source State taxes all these categories identically. In *Denkavit*, France imposed a liability to withholding tax on dividends received from a resident company by a non-resident parent company, regardless of the existence of a fixed place of business in France. As a result, the relevant characteristic (the liability to tax in the source State) is identical among both categories, which means that the object of comparison is entitled to non-discriminatory treatment (i.e., stated in terms of *ACT*: by imposing a charge to tax on dividends received by non-resident shareholders from a resident company, the situation of those non-resident shareholders becomes comparable to that of resident shareholders).

The influence of the tax treaty

A second issue concerned the influence of the provisions of the Dutch/French tax treaty on the French regime's compatibility with the Treaty freedoms. Because this issue concerns the influence of tax treaties on the disadvantage-test, it will be discussed in 2.E.I.B.e.5.

3. Amurta[1661]

The taxpayer, a company established in Portugal, held shares in a Dutch company. Pursuant to the tax laws in force in the Netherlands at the time, a 25% withholding tax was levied on any payment of dividends made by a company established in the Netherlands. However, an exemption from withholding tax applied if the shares in the distributing company were held either by shareholders subject to corporation tax in the Netherlands or by non-resident shareholders with a PE in the Netherlands, with the shares forming part of that PE's assets.

Article 10 of the Dutch/Portuguese tax treaty provided that dividends were taxable in the recipient's State of residence and that the source State could also tax those dividends at a rate not exceeding 10% of the gross amount of the dividends. Pursuant to Article 24 of the tax treaty, Portugal granted an ordinary credit to Portuguese residents receiving income which could be taxed in the Netherlands in accordance with the provisions of the treaty.

[1659] C-170/05, *Denkavit*, § 36-37.
[1660] C-170/05, *Denkavit*, § 38.
[1661] ECJ 8 November 2007, C-379/05, *Amurta SGPS v Inspecteur van de Belastingdienst/Amsterdam*.

Upon distribution of the dividends by the Dutch company, the Dutch tax authorities levied withholding at the rate of 25 % on the dividends paid to the Portuguese shareholder. As the tax treaty limited the source tax on dividends to 10%, the Portuguese taxpayer was entitled to a refund of 15%. Nevertheless, the shareholder claimed a refund of the full 25%, arguing that he should be entitled to the same exemption as shareholders resident in the Netherlands. According to the taxpayer, the Dutch withholding tax violated the free movement of capital, given its discriminatory effect as regards non-resident shareholders.

As to the first question, the Court applied its *ACT*-reasoning (see supra)[1662]. Applied to the facts of the case at hand, the Court thus observed that the economic double taxation to which outbound dividends were subject stemmed solely from the exercise by the Netherlands of its taxing powers. That is to say, the Netherlands subjected outbound dividends to tax while it elected to prevent such economic double taxation in respect of recipient companies established in the Netherlands or having a PE there which owned the shares. Consequently, the exercise by the Netherlands of its taxing powers as regards the dividends distributed to non-resident recipients **makes the situation of those recipient companies comparable** to that of resident recipients in relation to the prevention of economic double taxation of profits distributed by companies which are resident in that Member State.

There was also a second question to be addressed, namely whether the assessment of the compatibility of the Dutch system with the fundamental freedoms depended on whether the shareholder's State of residence granted the shareholder a full credit for the Dutch dividend tax. As this is an issue pertaining to the influence of tax treaties on the disadvantage-test, it will be discussed in 2.E.I.B.e.6.

4. Orange European Smallcap

As indicated earlier, part of the *Orange European Smallcap*-judgment concerned outbound dividends. More specifically, the concession granted to FIEs was reduced to the extent to which the shareholders of those enterprises were non-residents. If the shareholders of the FIE were exclusively residents of the Netherlands, the concession was equal to the amount of foreign tax which would be deductible from income tax if the dividend had been received exclusively by individuals resident in the Netherlands. If the shareholders of the FIE included non-residents, the concession was proportionally reduced according to the number of non-resident shareholders[1663]. The shareholders of OESF were individuals and legal persons, the majority of whom were residents of the Netherlands. The rest of the share capital was held by residents of other EU Member States, the Netherlands Antilles, Switzerland and the U.S.

The Dutch government argued that, as regards the possibility of crediting the tax deducted at source from dividends received abroad, resident shareholders of FIEs were incomparable to non-resident shareholders of such enterprises, as only the former category of shareholders was liable to income tax in the Netherlands and thus able to credit the tax deducted at source[1664].

[1662] C-379/05, *Amurta*, § 34-39. Since the facts of the case did not fall within the material scope of the Parent/Subsidiary-Directive, it was decided entirely under the fundamental freedoms.
[1663] For the purpose of that calculation, the following formula was used: T = B x (7 Sr) / (10 S – 3 Sr). Wherein: T is the concession, B is the amount of foreign tax, Sr is the amount paid on the shares or units in the collective investment enterprise which are held directly or through other investment enterprises by Dutch residents, and S is the amount paid on all shares or units in the collective investment enterprise which are in circulation.
[1664] C-194/06, *Orange European Smallcap Fund*, § 76.

The ECJ disagreed, thereby applying the reasoning set out above. The Court observed that the Netherlands taxed dividends which were distributed by an FIE to its shareholders, whether those shareholders were residents or non-residents. The Court therefore held that an FIE whose shareholders included non-residents could not be regarded as incomparable to an FIE whose shareholders were all residents. Accordingly, as soon as the Netherlands decided to grant FIEs established within its territory a concession for tax deducted abroad and to exercise its fiscal sovereignty over all dividends distributed by such enterprises to their shareholders, whether resident or not, it had to extend the benefit of that concession to FIEs whose shareholders included non-residents[1665].

5. Aberdeen[1666]

Aberdeen, a company established in Finland, distributed dividends to a real property SICAV ('société d'investissement à capital variable', i.e. an open-ended investment company) established in Luxembourg[1667]. The SICAV was not subject to income tax in Luxembourg, it was only subject to a tax on capital at the rate of 0.01%. Moreover, the profits it distributed to a person resident in another Member State were not subject to any withholding tax. The legal form of the SICAV was unknown in Finnish law.

Under Finnish tax law at the material time, dividends received by a resident company did not constitute taxable income, and no withholding tax was due on dividends paid by a resident company to another resident company or to a resident investment fund. In contrast, where a Finnish company distributed dividends to a SICAV established in another Member State, it was obliged to withhold tax at source. Under the tax treaty between Finland and Luxembourg, the amount of withholding tax was reduced to 5%.

The ECJ first noted that outbound dividends were subject to double taxation because of the withholding tax, since those dividends had already been taxed as profits realised in the hands of the distributing company. No such double taxation arose where the dividend was paid to a resident company or investment fund.

As to the comparability of the situations, the Court repeats its *ACT*-reasoning (see supra)[1668]. Yet, the Finnish government argued that that comparability-test could not be applied here. In particular, Finnish law did not allow companies to be set up in Finland with a legal form identical to that of a SICAV under Luxembourg law. Because of its legal form and tax treatment, a SICAV was not comparable to companies or investment funds established in Finland. Unlike a Finnish company, a SICAV was not subject to income tax in its Member State of residence (Luxembourg), it was only subject to a tax on capital at the rate of 0.01%. Moreover, the profits distributed by a SICAV to a person resident in another Member State were not subject to any withholding tax. In contrast, dividends received by Finnish companies were exempted from tax solely in order to avoid double taxation when profits were distributed between companies, while the other income of those companies was taxed. So the idea underlying this argument is that the risk of double taxation does not arise where the dividends

[1665] C-194/06, *Orange European Smallcap Fund*, § 78-79, referring to C-170/05, *Denkavit*, § 37 and the case law cited.
[1666] C-303/07, *Aberdeen Property Fininvest Alpha Oy*, 18 June 2009.
[1667] Since a SICAV was not a 'company of a Member State' as defined in the Parent-Subsidiary Directive, that Directive did not apply to the dividend payment.
[1668] C-303/07, *Aberdeen*, § 42-44.

are distributed to a Luxembourg SICAV, with the result that that SICAV is not comparable to a Finnish company as regards the Finnish measure designed to prevent double taxation.

The Court dismissed this argument. It held that the fact that in Finnish law there was no type of company with a legal form identical to that of a Luxembourg SICAV could not be taken into consideration in the comparison because the company law of the Member States has not been fully harmonised at EU level. Indeed, accepting that the mere difference in legal forms leads to incomparability would deprive the freedom of establishment of all effectiveness.

Secondly, the fact that the SICAV's income was not taxed in Luxembourg did not render it incomparable to a Finnish resident company as regards withholding tax on dividends received. Dividends paid in Finland by a resident company to another resident company were not taxed either by means of withholding tax or by forming part of the income of the recipient company. As pointed out above, dividends received by a resident company did not constitute taxable income for the recipient. As a result, neither the Finnish company, nor the Luxembourg SICAV was taxed on the dividend received from a Finnish resident company. Accordingly, the fact that the Luxembourg SICAV was not taxed on the dividend did not mean it was incomparable to a resident company[1669]. As to the fact that Luxembourg SICAV was not taxed on other income either, the Court held that the Finnish government had not shown why that was relevant for assessing the comparability as regards the exemption from withholding tax on dividends received.

Additionally, the Italian government argued that a real property SICAV was a transparent entity which aimed to add value to each member's individual contribution through collective management. The specific nature of such a SICAV justified it being exempted from income tax in its State of residence, since the only income to be taken into account is in reality that of each member. As a result, the problem of double taxation did not arise at the level of the SICAV but at the level of the members. Accordingly, that problem should be resolved by the Member State of residence of those members. On that basis, the Italian government argued that a real property SICAV was not comparable to a Finnish resident company.

The ECJ dismissed that argument as well. The Court simply recalled that it was Finland which created the double taxation by imposing withholding tax on income that had already been taxed at the level of the distributing company. And because Finland also chose to prevent such double taxation in the case of dividends distributed to resident companies, it could not be said that the responsibility to remove the double taxation was on the home State of the SICAV's members.

The Court therefore concludes that the Luxembourg SICAV was comparable to a Finnish company from the perspective of the Finnish rules at issue.

6. Conclusion: the ECJ's position on outbound dividends

As noted above, the ECJ's case law on the tax treatment of dividends has been described as confusing and inconsistent. The overview given here illustrates that a cursory reading of that case law may indeed cause some confusion, but that a closer look reveals that it is far from

[1669] The Finnish government also compared the Luxembourg SICAV to a Finnish investment fund, but because the ECJ already found that the SICAV was comparable to a Finnish company, it did not consider that additional comparison to be necessary (C-303/07, *Aberdeen*, § 55).

inconsistent. Indeed, the Court's approach is based on a consistent distinction between inbound situations and outbound situations, each of which is governed by its own comparability-analysis.

In outbound situations, the starting point of that analysis is the general assumption that non-resident shareholders are incomparable to resident shareholders because, in general, their ability to pay tax in the source State differs from that of residents. However, that is only the case where the tax benefit at issue serves to take account of the taxpayer's ability to pay tax. That is not the case, for instance, for domestic measures intended to prevent double taxation of dividends. For that reason, the Court dismisses the basic incomparability on the basis of ability to pay and considers a different relevant characteristic: the source State's exercise of taxing powers. In fact, this is the same principle as applied to other cases involving outbound payments (see 2.E.I.A.b.7) and income-related benefits (see 2.E.I.A.b.2): in those cases, the Court has consistently held that, from the perspective of the source State's legislation, non-resident recipients of payments are comparable to resident recipients if the source State exercises its taxing jurisdiction on the payments not only with respect to residents but also with respect to non-residents.

Yet, even though the ECJ's position is consistent, it is not entirely correct. As noted above, the reasons given for incomparability in outbound situations are not convincing. The Court distinguishes outbound situations from inbound situations on the basis of the different capacity of the Member States involved: the comparability-test is different depending on whether a State acts in its capacity as the shareholder's State of residence or as the distributing company's State of residence. But there is no apparent reason to distinguish between inbound situations and outbound situations with respect to comparability. The different capacity of the Member States involved is not relevant from the perspective of domestic measures intended to prevent double taxation[1670]. What is relevant in the context of such measures is the susceptibility to double taxation. If that characteristic is identical, the domestic and cross-border situation are comparable – irrespective of whether the cross-border situation concerns a non-resident shareholder or a non-resident distributing company. Of course, the different capacity of the Member States involved may play a role in the eventual justification of the measure, for instance as a matter of the balanced allocation of taxing powers, but it should not affect the comparability-analysis. From an internal market perspective, the only relevant characteristic for purposes of domestic measures intended to remove double taxation is whether the situations in question may face the same obstacle to cross-border (i.e. double taxation).

7. Withholding taxes on other outbound payments

As discussed above, the taxation of outbound dividends takes place in a specific legal context, given the close relationship between the taxation at the level of the distributing company and the taxation at the shareholder level. That special nature affected the Court's position on withholding taxes on outbound dividends. In the case of other outbound payments such as interest or royalties paid to a non-resident, the relationship between the taxation at the level of the payer and that at the level of the recipient is not that close. For that reason, the principles

[1670] And even if it was relevant, it should be disregarded in the comparability-test since it is inherent in the comparative attribute (the shareholder's place of residence). See 2.F.III.

developed by the Court with respect to withholding taxes on such payments are not entirely the same as with respect to withholding taxes on dividends.

a. Scorpio

The facts of Scorpio were already touched upon in 2.E.I.A.b.2.d. As pointed out there, German tax law provided that non-residents were liable to a tax of 15% in Germany on income from artistic performances in Germany. The tax was withheld at source by the debtor when the payment was made to the service provider. The debtor was responsible for retaining the tax and paying it to the German tax authorities.

Special rules applied if a tax treaty applied. If income subject to the obligation of retention at source was not taxable in Germany because of a tax treaty, the debtor still had to withhold the tax. Only if the German tax authorities certified on application that the relevant conditions of the tax treaty were met was the debtor not obliged to withhold the tax at source. Moreover, the non-resident recipient of the income was entitled to a reimbursement of the tax withheld at source, on application, to the extent provided for by the tax treaty.

In contrast, a German resident service provider declared his income in the general assessment procedure. Since the debtor of a payment to a resident was not obliged to withhold tax at source, that debtor could not incur liability by reason of not having made the retention, nor could he be held liable for the income tax due from the service provider.

Scorpio, a German resident company, paid a fee for an artistic performance to Europop, an individual resident in the Netherlands. Pursuant to the tax treaty between Germany and the Netherlands, the income from these services was only taxable in the Netherlands. Upon payment of the service fee to Europop, Scorpio did not withhold the tax at source, even though Europop had not presented the required certificate of exemption. The German tax authorities sent a notice of assessment to Scorpio, demanding payment of the amount of tax due from Europop (i.e. 15% of the gross amount of the service fee). Scorpio argued that the distinction between payments made to residents and payments made to non-residents as regards withholding obligations (and the resulting liability for the debtor) was contrary to the freedom to provide services.

It is important to note, first of all, that the alleged discrimination was between two residents: the subject of comparison is a resident who pays a fee for an artistic performance to a resident of another Member State, while the object of comparison is a resident who pays a fee for an artistic performance to a resident of the same Member State. The subject of comparison is obliged to make a retention of tax at source and he may incur liability if he fails to make that retention. Since both factors are liable to deter German residents from calling on providers of services residing in other Member States, the German measure restricted the free movement of services.

However, the Court decided that the measure was justified by the need to ensure the effective collection of income tax. According to the Court, *"the procedure of retention at source and the liability rules supporting it constitute a legitimate and appropriate means of ensuring the tax treatment of the income of a person established outside the State of taxation and ensuring that the income concerned does not escape taxation in the State of residence and the State where the services are provided."* Moreover, those measures were proportionate means of ensuring the effective collection of the tax debts. In particular, the potential liability of the payer enabled the absence of retention at source to be penalised if necessary. The Court noted that that liability constituted the corrollary of the method of collecting tax by means of a retention at source, with the result that it contributed in a proportionate manner to ensuring the effectiveness of collecting the tax[1671].

It should be pointed out that, at the material time, there was no Directive in force concerning mutual administrative assistance in the recovery of tax debts, nor was there another instrument in force between Germany and the Netherlands ensuring such mutual assistance. Apparently, that element affected the Court's conclusion that the measure was a legitimate and appropriate means of ensuring the effective collection of income tax[1672]. As will be pointed out below, the existence of instruments regulating mutual assistance was also relevant for the ECJ's decision in *Truck Center*.

Interestingly, the Court does not address the comparability of the situations, which seems to suggest that they are tacitly considered comparable[1673]. By contrast, in the cases involving outbound dividends, discussed in 2.E.I.A.b.6.c, the comparability-test was addressed at length. Here, however, the comparability seems more straightforward because the Court has repeatedly held that domestic situations and cross-border situations are comparable if the source State taxes both residents and non-residents on the same type of income[1674]. That was also the case in *Scorpio*: Germany taxed both fees paid to residents and fees paid to non-residents, with the result that the situations were comparable.

[1671] C-290/04, *Scorpio*, 3 October 2006, § 35-38. The Court reached a similar conclusion with regard to the question whether the special rules applying in case the income was exempt under a tax treaty were discriminatory. As pointed out above, the payer of the income could only refrain from retaining tax at source if a certificate of exemption was issued by the competent tax authority on application. The Court noted that such an additional administrative burden could restrict the free movement of services (without expressly addressing the comparability of the situations). However, the discrimination was justified in order to ensure the proper functioning of the procedure for taxation at source. For that purpose, it was important that the resident payer of the income could refrain from retaining tax at source only if he was certain that the recipient satisfied the conditions for an exemption. According to the Court, the payer could not be required to clarify himself whether or not, in each individual case, the income in question was exempt under a tax treaty. Finally, authorising the payer to unilaterally refrain from retaining the tax at source could, in the event of an error on his part, have the effect of compromising the collection of the tax from the recipient of the income (C-290/04, *Scorpio*, § 53-61).

[1672] See C-290/04, *Scorpio*, 3 October 2006, § 36.

[1673] It could be argued that the Court took the same position in C-433/04, *Commission v Belgium*. In that case as well, the Court only considered the disadvantage caused by the withholding obligation and the possible justification, without mentioning comparability, which could suggest that the Court implicitly considered payments to resident contractors and payments to non-residents contractors comparable as regards the withholding obligation. As pointed out in 2.D.V.C.d, however, it seems that the Court applied a restriction-analysis in that case, with the result that the comparability-test was not necessary.

[1674] E.g. C-234/01, *Gerritse*, § 27: *"the business expenses in question are directly linked to the activity that generated the taxable income in Germany, so that residents and non-residents are placed in a comparable situation in that respect"*; C-270/83, *Avoir fiscal*, 28 January 1986, § 20: *"By treating the two forms of establishment in the same way for the purposes of taxing their profits, the French legislature* ***has in fact admitted that there is no objective difference*** *between their positions in regard to the detailed rules and conditions relating to that taxation which could justify different treatment"* (emphasis added); C-370/04, *ACT*, § 68: *"once a Member State, unilaterally or by a convention, imposes a charge to income tax not only on resident shareholders but also on non-resident shareholders in respect of dividends which they receive from a resident company,* ***the position of those non-resident shareholders becomes comparable to that of resident shareholders****"* (emphasis added); C-11/07, *Eckelkamp*, 11 September 2008, § 62-63: *"By treating the inheritances of [resident and non-resident heirs] in the same way (except in relation to the deduction of debts) for the purposes of taxing their inheritance, the national legislature* ***has in fact admitted that there is no objective difference*** *between them in regard to the detailed rules and conditions relating to that taxation which could justify different treatment"* (emphasis added). Similarly: C-43/07, *Arens-Sikken*, 11 September 2008, § 57.

b. Truck Center[1675]

1. The Court's decision

Truck Center, a Belgian resident company, borrowed money from Wickler Finances, a Luxembourg company which held 48% of Truck Center's share capital. Truck Center entered the interest on the loan in its P&L account but did not pay it, and it did not retain any withholding tax. The Belgian tax administration sent a notification of assessment to withholding tax to Truck Center. For the years at issue, the rate was 13,39% and 15%.

Under Belgian domestic tax law, the charging of withholding tax was waived completely on income from debt-claims and loans, the beneficiaries of which were identified as professional investors. Professional investors were resident individuals who had contracted the loans in the context of their professional activity and resident companies. Art. 11 of the Belgian/Luxembourg tax treaty provided that interest payments were taxable both in the recipient's State of residence and in the source State, but that the tax levied in the source State could not exceed 15% of the amount of the interest.

The effect of the Belgian legislation was that the procedure for the charging of withholding tax varied depending on the place of residence of the company receiving the interest. Withholding tax is charged on interest paid to a non-resident recipient company, whereas it is not charged on interest paid to a resident recipient company. The ECJ was asked whether this distinction violated the free movement provisions.

The ECJ starts its analysis as regards the comparability of resident and non-resident companies by referring to its basic *Schumacker*-position, that in relation to direct taxes the situations of residents and non-residents are, as a rule, not comparable. In the case at hand, the ECJ decides on the basis of three arguments that that is also the case for residents and non-resident companies that receive Belgian source interest[1676].

First, the position of the Belgian State differs depending on the residence of the company receiving the interest. When both the company paying the interest and the company receiving the interest are resident in Belgium, the Belgian State acts in its capacity as the residencec State of the companies concerned. By contrast, when a company resident in Belgium pays interest to a non-resident company, Belgium acts in its capacity as the source State of the interest.

Secondly, the payment of interest by a resident company to another resident company and the payment of interest by a resident company to a non-resident company give rise to two distinct charges which rest on separate legal bases. In the first case, no withholding tax is charged on the interest, but in accordance with the provisions of Belgian national tax law, the interest is taxed in Belgium because it is subject to corporation tax in the hands of the receiving company and on the same footing as that company's other income. In the second case, Belgium levies withholding tax at source pursuant to the discretionary power which, by virtue of the Belgian/Luxembourg tax treaty, Belgium and Luxembourg have mutually reserved for themselves in the allocation of their powers of taxation. According to the ECJ, "*those*

[1675] The text of this section is based on L. DE BROE and N. BAMMENS, "Truck Center. Belgian withholding tax on interest payments to non-resident companies does not violate EC law: a critical look at the ECJ's judgment in Truck Center", *EC Tax Review* 2009, 131-137.
[1676] C-282/07, *Truck Center*, 22 December 2008, § 42-48.

different procedures for charging tax thus constitute a corollary to the fact that resident and non-resident recipient companies are subject to different charges".

Finally, resident and non-resident companies receiving interest payments from a resident company are in a different situation with regard to recovery of the tax. While resident recipient companies are directly subject to the supervision of the Belgian tax authorities, which can ensure compulsory recovery of taxes, that is not the case with regard to non-resident recipient companies inasmuch as, in their case, recovery of the tax requires the assistance of the tax authorities of the other Member State.

On the basis of these three arguments, the ECJ concludes that the situations are not comparable. Consequently, the different treatment does not give rise to discrimination.

As to the disadvantage-test, the ECJ points out that the subject of comparison is not necessarily placed at a disadvantage. According to the Court, the Belgian regime does not necessarily result in an advantage for resident recipient companies because, first, those companies are obliged to make advance payments of corporation tax and, secondly, the amount of withholding tax deducted from the interest paid to a non-resident company is significantly lower than the corporation tax charged on the income of resident companies which receive interest[1677].

In conclusion, the ECJ decides that the Belgian measure does not infringe the Treaty freedoms.

2. Commentary
Comparability – justification

The ECJ's reasoning in *Truck Center* calls for several observations. First of all, the manner in which the existence of discrimination is assessed is remarkable. On the basis of three arguments, the ECJ concludes that the situations of resident and non-resident companies are not comparable with respect to the Belgian measure at issue. Especially the third argument is striking, i.e. the direct supervision of the Belgian tax authorities over resident companies, which is absent with regard to non-resident companies. In order to recover taxes from the second category, assistance of the other Member State's tax authorities is required. Traditionally, the question as to the relevance of administrative nuisances is examined under the third step of the ECJ's analysis, i.e. the justification-test[1678].

Nevertheless, it is possible that the existence of administrative difficulties affects the comparability-test. In particular, the Court has repeatedly held that the free movement of capital in relation to third countries takes place in a different context from the free movement of capital between Member States[1679]. The reason for that difference is that there are a number

[1677] C-282/07, *Truck Center*, 22 December 2008, § 49-50.
[1678] E.g. C-204/90, *Bachmann*, § 18; C-1/93, *Halliburton*, § 21-22; C-279/93, *Schumacker*, § 43-45; C-55/98, *Vestergaard*, § 26; C-334/02, *Commission v France*, § 31; C-520/04, *Turpeinen*, § 35-37. It should also be noted that the existence of administrative difficulties is usually not accepted as a valid justification (as illustrated by the cases cited here). Its relative weakness as a justification ground makes it all the more remarkable that the administrative burden-argument is considered to render two situations incomparable in *Truck Center* (which inevitably means that no justification is necessary).
[1679] As will be pointed out in 2.E.I.A.b.8.b, the comparison is then made between two cross-border situations: a situation in the intra-EU context on the one hand, and a situation involving a third country on the other hand. This particular kind of comparison is mainly intended to clarify that the Court's traditional position as to

of legal instruments in force in the intra-EU context that reduce the administrative difficulties in levying taxes on non-residents (e.g. the Mutual Assistance Directive, harmonisation measures on company accounts, etc.). The applicability of those instruments explains why justification-grounds relating to administrative nuisances are generally dismissed in cases involving transactions between Member States. But those measures do not apply in relation to third countries, with the result that the Court's case law in this field cannot necessarily be transposed to such situations (see 2.E.I.A.b.8.b). In other words, the absence of obligations as to mutual assistance (and the resulting administrative difficulties) renders situations involving third countries incomparable to intra-EU situations. Obviously, that is not the same as taking the administrative difficulties resulting from the absence of mutual assistance into account when comparing residents and non-residents in an intra-EU context. It is therefore remarkable that the Court takes these nuisances into account in the comparability-test in *Truck Center*.

Of course, the mutual assistance issue in cases involving third countries, such as the *A*-case (discussed in 2.E.I.A.b.8.b), is not entirely the same as the mutual assistance issue in *Truck Center*. The cases discussed in 2.E.I.A.b.8.b concern transactions where the Mutual Assistance Directive does not apply. As a result of that non-applicability, the Court's traditional position as regards the lack of effective fiscal supervision cannot be transposed to those cases. Consequently, the lack of effective fiscal supervision could be successful as a justification ground in transactions involving third countries since there is no legal obligation on those countries to exchange information. In contrast, the issue in *Truck Center* did not concern information exchange, but mutual assistance for the recovery of tax claims. Since the Directive on mutual assistance for the recovery of tax claims[1680] did not apply to the tax years at issue in *Truck Center*[1681], it was necessary for Belgium to impose a withholding tax on payments made to non-residents in order to ensure that the tax due in Belgium would be paid. If there had been an obligation on Luxembourg to cooperate in recovering the tax claim of the Belgian tax authorities, it would not have been necessary to impose such a withholding tax since the tax could then be levied in the hands of the recipient.

Put briefly, the situation discussed in 2.E.I.A.b.8.b concerned mutual assistance as regards information exchange, while *Truck Center* concerned mutual assistance as regards the recovery of tax claims. Both of those issues therefore concern administrative difficulties in either assessing a non-resident to income tax or recovering the tax so assessed. And both of those issues can be resolved effectively by instruments that provide for a legal framework on mutual assistance between the tax authorities concerned. Consequently, the absence of such a legal framework justifies the different treatment of payments made to residents and payments made to non-residents. Since there is nothing to separate these issues from a theoretical point

---

justification grounds cannot necessarily be transposed to situations involving third countries. In other words, certain justification grounds will not be accepted in an intra-EU context, while they will be accepted in a situation involving a third country. From that perspective, those two situations are incomparable. That is what I mean by the statement that the existence of administrative difficulties may affect the comparability-test. Thus, when the analysis is made in a purely intra-EU context, that is to say, when the domestic situation is compared to the situation involving another Member State, the existence of administrative difficulties remains confined to the justification-test. In a situation involving a third country, on the other hand, such difficulties may come up for discussion in the comparability-test, albeit not in the comparison between the domestic situation and the cross-border situation: they are only relevant in the comparison between the cross-border situation involving a third country and a cross-border situation involving another Member State.

[1680] Council Directive 76/308/EEC of 15 March 1976 on mutual assistance for the recovery of claims resulting from operations forming part of the system of financing the European Agricultural Guidance and Guarantee Fund, and of the agricultural levies and customs duties, *OJ* L 73, 19 March 1976, 18-23.

[1681] And since the applicable tax treaty (or another bilateral instrument) did not create a similar legal framework to allow for such mutual assistance.

of view, there is no reason to give them a different position in the Court's decision tree. Accordingly, it would have been preferable for the Court to confirm its traditional position that administrative difficulties should be taken into account in the justification-test, not in the comparability-test.

The Advocate-General's position on comparability and justification

The shift in the Court's position may be inspired by the Advocate-General's Opinion in *Truck Center*. The Advocate-General held that *"in the present case the situation of recipients of interest within the country differs from the situation of those in another Member State with respect to the conditions for the charging and collecting of taxes. Companies within the country are subject directly to fiscal supervision in their State of residence. The tax authorities can assess them to tax and collect taxes by means of the exercise of public authority. That is not automatically possible in the case of companies resident in another Member State, where cooperation with the fiscal administration of the other Member State is necessary"*[1682].

In order to support this position, the Advocate-General referred to the Court's decision in *Scorpio*, where it was held that the German withholding tax on payments made to non-residents was justified by the need to ensure the effective collection of income tax (see supra)[1683].

Thus, the Advocate-General in *Truck Center* transposes a justification-argument to the comparability-analysis. In my view, the three steps of the discrimination-analysis should remain separated - as they were in *Scorpio* - given their respective importance and the conditions which a justification ground must meet. It is therefore unfortunate that the ECJ in *Truck Center* retracted from the rigourous analysis it has adopted in *Scorpio* and incorporated the administrative difficulties into the comparability-analysis. A theoretically sound approach requires a comparability-analysis without interference from justification-arguments. In the present case, this would mean that, leaving aside the ECJ's other two arguments (which will be discussed below), the Court should have assumed comparability because the source State (Belgium) taxes resident and non-resident recipients on the same type of income (interest) and conclude that there was a different treatment to the detriment of the non-resident. Subsequently it should have tested whether the administrative burden could justify the discrimination. In that respect, an inquiry into the suitability and proportionality of the measure should come up for discussion as well.

[1682] Opinion of Advocate-General Kokott in C-282/07, *Truck Center*, 18 September 2008, § 34.

[1683] It has been suggested that the fundamental difference between the Court's reasoning in *Scorpio* and in *Truck Center* is that the analysis in *Scorpio* is made from a home State perspective (i.e. by focusing on the person who was obliged to retain tax at source when making payments to a non-resident), whereas the issue in *Truck Center* is addressed from a host State perspective (i.e. by focusing on the non-resident recipient of income who is subject to a withholding tax at source). This conceptual difference may have important repercussions: when focusing on the payer, the emphasis in the justification-test will most likely be on the compliance burdens and liability risks, while a focus on the beneficiary would likely give more weight to cash-flow disadvantages (J. ENGLISCH, "Comments on Truck Center", *Highlights & Insights on European Taxation* 2009, 2, 49). In my opinion, however, both *Scorpio* and *Truck Center* were decided from a home State perspective. In *Truck Center*, the three arguments in the comparability-test all concern the tax authorities of the home State (i.e. Belgium), albeit in relation to the non-resident recipient of the income. According to the Court, the position of the Belgian tax administration as regards the payment renders the situations incomparable. Thus, the analysis is still made from a home State perspective. On the fact that the Court assumed the perspective of the tax authorities, rather than that of the taxpayer: see infra.

Such an inquiry is nowhere to be found in the ECJ's analysis in *Truck Center*, but the Advocate-General incorporates it into the comparability-test as well. After observing that residents and non-residents are in different situations because of the different degree of fiscal supervision exercised by the source State, the Advocate-General observes that *"for a finding of non-discrimination, it is not sufficient to point out that citizens and foreign nationals are not in the same situation. It is also necessary to demonstrate that the difference in their respective situations is capable of justifying the difference in treatment. In other words, the difference in treatment must relate and be proportionate to the difference in their respective situations"*[1684]. Accordingly, the Advocate-General draws a direct link between comparability and justification: in order for a difference in the relevant situations to lead to a finding of non-comparability (and thus non-discrimination), the difference must be *"capable of justifying the difference in treatment"*, i.e. it must *"relate and be proportionate to the difference in their respective situations"*.

Thus, the Advocate-General goes on to examine whether the method of deducting tax at source on interest payments to non-resident recipients is a proportionate response to the difficulties in collecting taxes that would occur if the Belgian tax authorities had to collect the tax directly from the non-resident recipient of interest. In this respect, the Advocate-General observes that the method of deducting tax at source is *"a suitable means of taking account of the different situation of resident and foreign recipients of interest payments."*

The Advocate-General then tests the proportionality of the measure, thereby once again referring to *Scorpio.* In *Scorpio* the ECJ emphasized in this respect that at the material time there were no EU instruments on mutual administrative assistance for the recovery of tax debts (see supra). In the tax years at issue in *Truck Center* (1994-1996), Belgium was likewise unable to rely on Directive 76/308/EEC to facilitate the recovery of taxes in another Member

---

[1684] Opinion of Advocate-General Kokott in C-282/07, *Truck Center*, § 37, referring to the opinion of Advocate-General Poiares Maduro in C-524/06, *Huber*, § 7. The *Huber*-case concerned German rules on the processing of personal data, which were more stringent with regard to foreign nationals. The German government argued that German nationals and foreign nationals were not comparable because their residence status was fundamentally different: the former had an unlimited right to reside in Germany while the latter had no such right. As a response to this argument, Advocate-General Maduro made the observation which is quoted by Advocate-General Kokott in her opinion in *Truck Center*. According to A.-G. Maduro, stating that the residence rights of German citizens and foreign nationals are not the same, *"is no more than stating the obvious; it says nothing about how this difference in residence status should relate to the collection and processing of the personal data of German citizens and citizens of other Member States. […] For a finding of non-discrimination, it is not sufficient to point out that German citizens and foreign nationals are not in the same situation. It is also necessary to demonstrate that the difference in their respective situations is capable of justifying the difference in treatment. In other words, the difference in treatment must relate and be proportionate to the difference in their respective situations. Therefore, […] in order to decide whether a German national is in a comparable situation to an EU national in relation to the collection and processing of personal data by the German authorities, we need to examine the purposes for which this collection and processing takes place."* However, Advocate-General Maduro does not elaborate on this 'proportional comparability'-test in the remainder of his opinion. Instead, he applies the traditional test and analyzes whether the different treatment is justified by the grounds put forward by the German government (thereby implicitly accepting that the categories are comparable; see § 8 *et seq.* of the Opinion in *Huber*). Furthermore, the ECJ did not apply this analysis in its judgment in *Huber*. Instead, it simply considered both categories to be comparable (C-524/06, *Huber*, § 75-76).

State[1685] (or on a clause in the Belgium/Luxembourg tax treaty to that effect), since the scope of that Directive was only extended to direct taxation in 2001[1686].

However, there was a similar instrument in force at the time, namely the Benelux Convention on mutual administrative assistance in the recovery of tax claims of 5 September 1952. Thus, the Advocate-General considers *"whether charging the withholding tax in the hands of the Luxembourg recipient of the interest payment – calling if need be on the administrative assistance of the Luxembourg tax authorities – might not be a less intrusive measure than deducting tax at source."* The Belgian government disputed the relevance of the Benelux Convention, arguing that the withholding tax was deducted from a taxable person within the Belgian territory, with the result that there was no need for administrative assistance.

The Advocate-General correctly points out the fallacy of this reasoning: the existence of the Benelux Convention could precisely allow for the collection of withholding tax in such a way that it would not have to be deducted at source by the interest debtor but would be charged against the foreign recipient of the interest. Yet, collecting tax from the non-resident recipient is not necessarily less burdensome than collection at source from the domestic payor of the interest, even though the existence of mutual assistance might alleviate the administrative burdens arising in this respect. If the non-resident recipient were liable for the Belgian withholding tax, it would have to file a return in Belgium, despite not being resident there. The Belgian tax authorities would have to register the recipient as a taxable person and supervise the filing of the tax return and the payment of the tax. Where the non-resident fails to pay the Belgian tax they would also have to turn to the authorities of the State of residence of the recipient of interest by means of administrative assistance for purposes of enforcement.

Altogether, this form of tax collection would probably give rise to substantially greater expenses for the tax authorities and for the group of companies, than taxation at source in the hands of the resident company paying the interest, which is liable to tax in Belgium in any event. Especially in the case of one-off or small tax claims, the additional expense would be out of proportion to the administrative burden of deducting tax at source. In conclusion, the Advocate-General holds that the Belgian measure is not necessarily disproportionate. In fact, *"creating a proportionate procedure for collecting taxes requires a complex assessment which the national legislature has to undertake when it exercises its competence to regulate direct taxation."* In the present case, the Advocate-General decides that the Belgian legislature has not obviously exceeded its margin of discretion by introducing a withholding tax, even though Belgium could rely on a bilateral agreement for administrative assistance for the enforcement of taxes abroad[1687].

That line of reasoning is quite remarkable. By drawing a direct link between the proportionality of the measure at issue and the comparability of the situations, the boundaries between the comparability-test and the justification-test are blurred. In my view, the

[1685] That Directive was originally developed to cover agricultural levies and customs duties (as traditional sources of Community revenue), but it was later extended to cover VAT (Council Directive 79/1071/EEC), excise duties (Council Directive 92/108/EEC) and direct taxation (Council Directive 2001/44/EC). The Directive and the acts amending it were codified by Directive 2008/55/EC of 26 May 2008, which was replaced by Directive 2010/24/EU of 16 March 2010.

[1686] Council Directive 2001/44/EC of 15 June 2001 amending Directive 76/308/EEC on mutual assistance for the recovery of claims resulting from operations forming part of the system of financing the European Agricultural Guidance and Guarantee Fund, and of agricultural levies and customs duties and in respect of value added tax and certain excise duties, *OJ* L 175, 28 June 2001 17-20.

[1687] Opinion of Advocate-General Kokott in C-282/07, *Truck Center*, § 47.

proportionality of the measure (which, in the present case, is scrutinized by comparing it to the alternative of mutual assistance) should remain confined to the third step of the ECJ's analysis. In the ECJ's traditional analysis, the finding of comparability logically implies the necessity of equal treatment, unless valid grounds of justification are advanced. In the opposite scenario, the finding of incomparability logically implies the necessity of inequal treatment, barring the existence of valid grounds of justification. The Advocate-General's opinion seems to propose a new type of analysis, in which two situations are never merely comparably, but rather sufficiently comparable or insufficiently comparable to justify a different treatment.

By stating that *"the difference in treatment must relate and be proportionate to the difference in their respective situations"*, it seems that the Advocate-General merges the three separate steps into one amalgamate analysis. Under such an analysis, one would no longer first determine whether the situations are comparable, subsequently examine whether both situations are treated differently and finally assess possible justifications (including a necessity- and proportionality-test). Instead, one would consider whether the difference in treatment is proportionate to the difference in the situations[1688]. A sliding scale would apply, which would allow for major differences in treatment when the situations differ significantly, but which would only allow for minor differences in treatment when the situations are more or less comparable. This seems to be a notable departure from the current clear-cut analysis and would, in my estimation, be rather unpredictable in its outcome[1689].

The ECJ does not follow suit in its judgment in *Truck Center*. The Court does not address the relevance of the Benelux Convention, nor the impact it might have on the proportionality of the measure at issue. The only (in abstracto) reference to mutual assistance in the Court's judgment is made with regard to the difference between residents and non-residents as to the degree of supervision exercised by the Belgian tax authorities[1690]. As indicated earlier, the ECJ held in this regard that the absence of direct supervision by the tax authorities over non-residents implied that recovery of the tax required the assistance of the tax authorities of the other State. No further thought was given to the specific implementation of assistance which was available in the case at hand. Instead, the mere necessity of administrative assistance, whatever its form, renders the situations incomparable according to the Court. The ECJ therefore concludes that the Belgian legislation did not give rise to discrimination.

In other words, the Court does not relate the proportionality of the measure (as expressed by the feasibility of its alternative, i.e. the mutual assitance procedure) to the degree of difference existing between the situations. The incomparability means that no discrimination arises, regardless of the extent to which the measure at issue treats both categories differently. Arguably, this question should have come up in the ECJ's second step (i.e. whether the difference in treatment was non-existent) and its third step (i.e. whether the difference in treatment was proportional to the requirement of general interest it sought to attain).

[1688] In fact, one could read this as a literal application of the second part of the Aristotelian concept of non-discrimination: *"things that are unalike should be treated unalike* ***in proportion to their unalikeness****."*
[1689] Of course, the comparability of the situations in the traditional analysis should be assessed in the light of the measure at issue, but that is not the same as relating the degree of difference between the situations to the degree of different treatment introduced by the measure. On the difference between justification grounds and elements of the comparability-test, see 2.F.III.
[1690] C-282/07, *Truck Center*, 22 December 2008, § 36, see supra.

Interest – dividends

The ECJ's first argument, concerning the position of Belgium as residence State or source State, is remarkable as well. At first sight, this difference in position is a direct consequence of the taxpayer being a resident or not, which would mean that the ECJ's argument is based on circular reasoning. Indeed, Belgium always acts as the source State with regard to non-residents and as the residence State with regard to residents. It does not seem very convincing to argue that residents and non-residents cannot be compared because Belgium acts as the State of residence with regard to the first category and as the source State with regard to the second category[1691]. This would mean that residents and non-residents are never comparable.

However, one must read this first argument in conjunction with the second one, and keep in mind that *Truck Center* concerns interest payments, which means that the comparison with *Amurta* and *Denkavit* does not hold (see infra). The ECJ's second argument was that interest received by a Belgian company is subject to the Belgian corporate income tax in the hands of the receiving company, whereas the fact that non-resident companies are not subject to the corporate income tax means that the withholding tax is a necessary means to recover the taxes if such companies receive Belgian-sourced interest.

As the Advocate-General rightly observes in her opinion in *Truck Center*[1692], the situation was different in *Amurta* and *Denkavit*. The systems at issue in those cases were intended to avoid economic double taxation of dividends distributed to a recipient with liability to corporation tax. In order to do so, the dividends were exempt from tax altogether in the hands of the recipient, since the underlying income had already been subject to corporation tax in the hands of the company paying the dividend. Accordingly, in *Amurta* and *Denkavit*, it was held that resident and non-resident shareholders were comparable as soon as a Member State taxed not only resident shareholders but also non-resident shareholders on dividends received from a resident company. It is solely because of the exercise by that State of its taxing powers that, irrespective of any taxation in another Member State, a risk of a series of charges to tax or economic double taxation may arise. In such a case, the non-discrimination principle requires the source State to extend the measures to avoid double taxation to non-residents[1693].

By contrast, the exemption from withholding tax on interest paid to Belgian companies is not aimed at exempting the interest from tax altogether in order to avoid economic double taxation. Unlike dividends, the interest is not paid out of income of the paying company on which tax has already been paid. Rather, corporation tax becomes payable on the income from interest only in the hands of the recipient. Thus, in the case of interest payments, the withholding tax is a necessary means for Belgium to exercise its power of taxation as allocated in Art. 11 of the Belgian/Luxembourg tax treaty, since it overcomes the problems arising in the taxation of non-residents' income and the collection of taxes against non-residents. In the case of interest paid to residents, no withholding tax is levied because the income is taxed on assessment in the hands of the recipient. Given the problems arising in taxing non-residents, that exemption cannot be extended to interest paid to non-residents[1694].

[1691] See also supra, 2.E.I.A.b.6.c.1, on the *ACT*-case, where the capacity of the Member State involved as source State or residence State was also taken into account in the comparability-analysis.
[1692] Opinion of Advocate-General Kokott in C-282/07, *Truck Center*, § 62 *et seq.*
[1693] C-170/05, *Denkavit*, § 35-37 and C-379/05, *Amurta*, § 38-40 (see supra, 2.E.I.A.b.6.c).
[1694] Worded differently, interest payments are a deductible expense for the paying company and are taxable income for the recipient company. If the recipient is established in Belgium, that tax is levied on assessment. If the recipient is established abroad, it is levied by means of a withholding tax. Accordingly, both recipients only pay tax once in Belgium. The Court does not address the possibility that the recipient will also be subject to

This reasoning bears close resemblance to the ECJ's third argument, discussed above. Given the identity of the underlying grounds, the remarks we made earlier with respect to the necessity of distinguishing the three steps are valid here as well.

Once again, it is necessary to stress the importance of the sudden shift in the Court's reasoning as compared to earlier case law. As indicated earlier, the Court's comparability-analysis in *Truck Center* is actually based on arguments which are traditionally found in the justification-test. But that is not the only worrying aspect of the inclusion of these arguments in the comparability-analysis. By expressly assuming the perspective of the tax authorities in the comparability-test, the ECJ seems to depart from its earlier case law, where the comparability of the situations was always assessed from the taxpayer's perspective[1695]. From the taxpayer's perspective, Truck Center's situation is comparable to that of a Belgian resident subsidiary paying interest to its Belgian resident parent company. Both payments are deductible for the subsidiary and both are taxable income for the parent in the corporation tax (whether in Belgium or in Luxembourg). From the perspective of the tax authorities, however, the situation of a resident taxpayer is always different from that of a non-resident taxpayer, given the different scope of tax liability and the different degree of administrative oversight. Assuming the perspective of the tax authorities in the comparability-test would therefore severely limit the scope of application of the fundamental freedoms in the area of direct taxation. Ultimately, the Court's remarkable position on comparability, including the argument that the administrative issues as to the recovery of tax claims render the situations incomparable, can be explained by the unfortunate fact that the Court in assumes the perspective of the tax authorities in *Truck Center*, rather than that of the taxpayer.

Exclusive source State taxation – shared tax jurisdiction

Finally, the ECJ examines whether the Belgian measure results in a disadvantage for the subject of comparison[1696]. In this regard, the Court observes that the difference in treatment does not necessarily produce a benefit for Belgian companies because those companies are obliged to make advance payments of corporation tax and, moreover, the amount of withholding tax deducted from the interest paid to a non-resident company is significantly lower than the corporation tax charged on the income of resident companies[1697].

The Advocate-General made a similar analysis in this context as well. Unlike the Court, however, she also examined whether the non-deductibility of costs in the withholding tax affected the outcome of this inquiry. In earlier decisions[1698], the ECJ held that a national provision which denies non-residents a deduction of business expenses, whereas residents are

corporation tax on the interest in his State of residence (Luxembourg). But that 'double burden' could easily be dismissed by referring to *Kerckhaert-Morres* (see 2.D.V.C).

[1695] See also F. VANISTENDAEL, "België in de Europese kijker", *A.F.T.* 2009, 3, 2.

[1696] C-282/07, *Truck Center*, 22 December 2008, § 49-50. Obviously, that analysis was redundant since the Court had already decided that the situations were incomparable, with the result that there was no discrimination.

[1697] That is not always correct. Loss making resident companies will not make advance payments. Thus, a non-resident loss making company that is subject to Belgian withholding tax clearly suffers a definitive disadvantage which similar resident company do not suffer. Furthermore, the withholding tax on interest paid to a non-resident company will be deducted upon payment, whereas the advance payments of corporation tax are payable on fixed dates throughout the taxable period. For instance, when an interest payment is made to a non-resident company on 10 January, the withholding tax will be deducted on 10 January. By contrast, a resident company receiving an interest payment on 10 January will make its first advance payment of corporation tax on 10 April (Art. 159 ITC). The ECJ should therefore have repeated its consistent case law that even minor cash-flow disadvantages may give rise to discrimination (see infra, 2.E.I.B.b).

[1698] E.g. C-234/01, *Gerritse*, § 28; C-346/04, *Conijn*, § 26 (see 2.E.I.A.b.2).

allowed to claim such a deduction, constitutes discrimination. The Advocate-General in *Truck Center* observes that *"in those cases the income was fully and entirely subject to tax at the place where the services were provided and was presumably exempt from tax, or largely relieved by set-off of the foreign tax, at the seat of the provider of the services. It was thus in accordance with the principle of fiscal symmetry to include operating expenses in the basis of assessment in the State which essentially taxes the income connected to them"*[1699].

In the situation of *Truck Center*, by contrast, Belgium and Luxembourg had agreed that – apart from the Belgian withholding tax of 15% – Luxembourg could tax Belgian-sourced interest. According to the Advocate-General, *"it would accordingly appear natural also to take the operating expenses into account in the context of taxation in Luxembourg."* Consequently, the Advocate-General distinguishes cases concerning exclusive source State taxation (e.g. *Gerritse* and *Conijn*) from cases concerning shared tax jurisdiction (e.g. *Truck Center*). In the first category, the non-deductibility of costs for non-residents would be discriminatory, while no such discrimination would arise in the second category.

However, this distinction is hard to maintain in the light of the ECJ's decision in *Bouanich*, concerning the source State taxation of dividends (and thus also a matter of shared tax jurisdiction, see Art. 10 OECD MC). In *Bouanich*, the ECJ held that the non-resident should be able to deduct costs from the dividend subject to withholding tax in order to avoid discrimination with residents who could claim such a deduction[1700]. In the Advocate-General's Opinion in *Bouanich*, the deductibility-issue was addressed without distinguishing between cases concerning exclusive source State taxation (e.g. *Gerritse* and *Conijn*) and cases concerning shared tax jurisdiction (such as *Bouanich*): *"Irrespective of a shareholder's residence, in the event of a company repurchasing its own shares the costs of acquisition incurred are directly connected to the proceeds of sale later received. The very condition for receiving proceeds of sale in the event of a share repurchase is the investment of capital. To that extent, the present case does not differ therefore from, for example, Gerritse in which the Court assumed that residents and non-residents were comparably situated as regards their business expenses incurred in generating their income. Just as in Gerritse there was no objective reason for denying non-residents the ability to deduct their business expenses, in the present case there is equally no apparent objective reason for precluding shareholders not resident in Sweden from deducting their acquisition costs"*[1701].

The ECJ's decision in *Bouanich* follows the same reasoning: *"the cost of acquisition is directly linked to the payment made on the occasion of a share repurchase so that, in this regard, residents and non-residents are in a comparable situation. There is no objective difference between the two situations such as to justify different treatment on this point as between the two categories of taxpayers"*[1702].

The ECJ does not discuss the deductibility of costs in *Truck Center* at all. It is submitted that the *Gerritse/Conijn/Bouanich*-reasoning should have been followed in *Truck Center* as well. As a result of the direct link between the income in question and the related costs, these costs affect the income received by all taxable persons in the same way, whether resident or non-resident. As a result, both categories are in comparable situations with respect to rules

[1699] Opinion of Advocate-General Kokott in C-282/07, *Truck Center*, § 70.
[1700] C-265/04, *Bouanich*, 19 January 2006.
[1701] Opinion of Advocate-General Kokott in C-265/04, *Bouanich*, 14 July 2005, § 39.
[1702] C-265/04, *Bouanich*, 19 January 2006, § 40.

governing the deductibility of costs, and both categories are entitled to equal treatment in this regard.

Of course, it may be quite burdensome to determine whether costs are directly related to the interest in question. In this regard, it has been submitted that a viable solution may be to offer non-resident lenders the option to be taxed on net interest in the source State and thus to prove their directly related costs[1703]. Non-resident lenders who feel they cannot overcome this burden of proof will suffer the discrimination in the source State but have the right to deduct the cost in their State of residence. Obviously, where the costs are deducted in the source State, the State of residence should be entitled to enact measures preventing the deduction there.

> With respect to the issue of cost-deductibility, the Advocate-General adds that *"there is no indication in the order for reference that the deduction of operating expenses is contested in the main proceedings. In addition, there are scarcely likely to be significant operating expenses in connection with loan transactions between associated undertakings"*[1704]. This is a remarkable observation. In reality, intragroup financing is often funded by loans as well and in case of a special purpose vehicle engaging in only one financial transaction, all its expenses are directly connected to the loan of which the interest is taxed in the source State. Moreover, could the Advocate-General's position be maintained where the lender were a non-resident bank[1705] instead of a group company? Banks finance their activities essentially by client deposits and other third party funding[1706]. One is left to wonder what could inspire such a sweeping statement, which seems to be added to the opinion as an afterthought.

8. The influence of information exchange on the comparability-test

a. Talotta[1707]

Mr Talotta, a Luxembourg resident who ran a restaurant in Belgium, was late in submitting his tax return for the purposes of the Belgian non-residents' income tax. The Belgian tax administration therefore determined his taxable profits by applying the minimum tax base provided for by Article 342(2) of the Belgian Income Tax Code (ITC), which allowed the tax authorities, in the absence of evidence provided either by the taxpayer or by the tax authorities, to tax foreign businesses operating in Belgium on the basis of a minimum tax base. The minimum tax base of foreign catering businesses operating in Belgium was determined on the basis of the turnover and the size of the workforce.

Mr Talotta argued that the rules laid down in Article 342(2) ITC discriminated against non-residents because, in the case of residents, the tax authorities could also apply other methods to determine the taxable profits. In particular, Article 342(1) ITC provided that, in the absence of evidence, the taxable profits of residents could be determined by analogy with the normal

---

[1703] L. DE BROE, "Are we heading towards an internal market without dividend withholding tax but with interest and royalty withholding tax? Some observations on Advocate General Kokott's opinion in Truck Center", *EC Tax Review* 2009, 1, 3.
[1704] Opinion of Advocate-General Kokott in C-282/07, *Truck Center*, § 71.
[1705] A matter which was at issue in C-105/08, *Commission v Portugal*, 17 June 2010. Unfortunately, however, the Court did not address the substantive issue in that case, because the Commission failed to establish that there was a disadvantage (see 2.E.I.B.1.2).
[1706] L. DE BROE, *o.c.*, *EC Tax Review* 2009, 1, 3.
[1707] C-383/05, *Talotta*, 22 March 2007, *ECR* 2007, I-2555.

profits of at least three similar resident taxpayers ('the comparison-based procedure'). Furthermore, Article 341(1) ITC provided that the profits of resident taxpayers could be assessed on the basis of signs or indications that the level of economic well-being enjoyed was higher than that accounted for by the income declared.

The Belgian government argued that there was no discrimination because residents and non-residents were in objectively different situations with respect to the determination of the taxable base. In support of this argument, the government referred to the difficulties in determining the tax base of a non-resident taxpayer, due to the territorial limits of the investigatory and monitoring powers of the tax authorities. As a result, the comparison-based procedure that could be applied to resident taxpayers, could not be applied to non-residents because the information available in Belgium was generally insufficient to identify points of comparison with comparable taxpayers. For instance, information relating to the purchase of raw materials in the taxpayer's country of residence could be difficult to obtain because it was located abroad.

Thus, the lack of information needed to apply the comparison-based procedure made it necessary to have recourse to minimum tax bases. According to the Belgian government, it was *"neither realistic nor effective"*, as a means of overcoming these practical problems, to engage in an exchange of information with the State of residence using the mechanism provided for in the Mutual Assistance Directive. More specifically, the Belgian tax authorities do not have the benefit in such cases of information sent by the State of residence in the context of spontaneous or automatic exchanges of information. Furthermore, the Belgian tax authorities do not have precise factual evidence, with the result that the request for exchange of information would not be admissible.

According to the Belgian government, such practical difficulties did not arise in situations involving residents, where it was always possible to apply the comparison-based procedure.

Secondly, the Belgian government argued that the alternative procedure available in the case of residents, i.e. the determination of the taxable base on the basis of signs and indications, could not be applied to non-residents because it was impossible to distinguish between the part of the income determined by reference to income indicators attributable to their activities located in Belgium and the part attributable to activities carried out in their country of residence. In particular, the tax authorities were unable to use information concerning a non-resident's lifestyle and personal and family situation because such information was too general and not capable of showing to what extent the information obtained was attributable to activities carried on in Belgium, and to what extent it related to activities located in his country of residence. As a result, it was necessary to resort to the application of minimum flat-rate bases. Consequently, since the situations were not comparable, there was no discrimination[1708].

The ECJ dismissed this argument, pointing out that, in cases where a part of their operations is carried out in the territory of a Member State other than that in which they carry out their self-employed activities, a resident taxpayer and a non-resident taxpayer present, for the tax authorities concerned, the same difficulties, with the result that those two categories of taxpayers are in an objectively comparable position. Moreover, in such a situation, a Member State can rely on the Mutual Assistance Directive in order to obtain from the competent

[1708] C-383/05, *Talotta*, § 27 and Opinion of Advocate-General Mengozzi in C-383/05, *Talotta*, § 51-59 and 70.

authorities of the other Member State all the information necessary to ascertain the correct amount of income tax[1709].

Finally, the ECJ indicates that the comparability of the situations of residents and non-residents is in no way affected by the Belgian government's observation that the minimum tax bases provided for in the national legislation are often more favourable to non-resident taxpayers than the comparison-based taxation applied to resident taxpayers[1710]. As this aspect of the judgment is an aspect of the disadvantage-test, it will be discussed in 2.E.1.B.c.6.

Only one ground was advanced by the Belgian government to justify the application of the minimum tax bases only to non-residents: the need to ensure the effectiveness of fiscal supervision. More specifically, the comparison-based method of taxation, as applicable to resident taxpayers, did not apply to non-resident taxpayers because of the practical difficulties, in particular the impossibility to apply the Mutual Assistance Directive. In this regard, the ECJ refers to the observation it made earlier, in the context of the comparability-test, i.e. that those practical difficulties apply in the same way to resident taxpayers and that it is open to the Member State concerned, on the basis of the Mutual Assitance Directive, to enter into an exchange of information with other Member States. Consequently, the argument was dismissed[1711].

Commentary

An interesting aspect of *Talotta* is that the Court seems to attach some weight to the applicability of the Mutual Assistance Directive in the comparability-analysis. In particular, the Court points out that residents and non-residents are in a comparable situation as regards the means of proof available to establish the taxable base. Both categories of taxpayers present the same difficulties for the tax authorities concerned.

This argument was addressed in more detail in the Advocate-General's Opinion. The Advocate-General correctly points out that the difficulties invoked by the Belgian government, concerning the obtaining of the necessary factual information to apply the comparison-based procedure, exist regardless of the taxpayer's residence. In particular, the essential elements relevant to the comparison-based procedure do not concern aspects relating to the taxpayer's place of residence. Under that procedure, account is taken of elements relating to activities carried on as a self-employed person in Belgium. While it is true that the determination of such elements may involve taking account of factors extraneous to Belgian

---

[1709] C-383/05, *Talotta*, § 28-29.

[1710] C-383/05, *Talotta*, § 31. In dismissing this argument, the ECJ implicitly confirms the three-step nature of its discrimination-test. The first step, the comparability-test, should be left unaffected by the second test, the question whether the measure at issue gives rise to unequal treatment. More specifically, the Belgian government's contention that the positive effects the disputed measure may have on the complaining taxpayer does not influence the assessment of the comparability. Only if the situations are found to be comparable, will the question as to equality of treatment become relevant.

[1711] C-383/05, *Talotta*, § 35-37. It is useful to point out that the Benelux Court tested the same Belgian regime against Articles 2 and 59 of the Benelux treaty in the *Metabouw*-case (A 2006/2/11, 19 March 2007). Article 2(2)(a) and (f) provide that the nationals of the Benelux States enjoy the same treatment as nationals of the other Benelux States as regards freedom of movement and taxes. Article 59 provides that companies of a Benelux State are not subjected to higher fiscal charges in the territory of the other Benelux States than those borne by similar national companies. The Benelux Court held that the Belgian regime infringed those provisions of the Benelux treaty since it could result in a higher fiscal charge being imposed on companies of another Benelux State. Unlike the ECJ in Talotta, the Benelux Court did not consider whether the discrimination was justified on the basis of a public policy objective.

territory, that eventuality is not necessarily linked to the residence of the taxpayer in question. For instance, any taxpayer may purchase raw materials from foreign suppliers. Consequently, the same difficulties regarding determination of the tax basis would arise in the case of a resident taxpayer as in the case of a non-resident taxpayer.

The Advocate-General also disagrees with the Belgian government's contention that it may be impossible to obtain the relevant information under the Mutual Assistance Directive, pointing out that the Directive may be invoked by a Member State to obtain from another Member State any information which is relevant and appropriate for determining the ability to pay tax. Therefore, the Advocate-General considers residents and non-residents to be comparable from the perspective of the comparison-based procedure[1712].

Since this argument is addressed in detail under the comparability-analysis, both by the Court and the Advocate-General, it is remarkable that the same argument is dealt with once again in the context of the justification-test[1713]. Indeed, the justification argument brought forward by the Belgian government – that the discrimination was justified by the need to ensure the effectiveness of fiscal supervision – boils down to the exact same argument as dealt with in the comparability-test.

As regards comparability, the argument of the Belgian government is that non-residents cannot be compared to residents because of practical difficulties arising in obtaining the necessary information as regards the former category of taxpayers. This argument is dismissed both by the Court and by the Advocate-General by pointing out that (1) those difficulties also arise with respect to residents and (2) assuming that there are indeed more difficulties as regards non-residents, the Member State in question can rely on the Mutual Assistance Directive to obtain the necessary information. Consequently, there is no difference between both categories as to the existence of practical difficulties. As a result, those categories are comparable.

As regards justification, the argument of the Belgian government is that the comparison-based method cannot be applied to non-residents because of the lack of the necessary information. Consequently, the effectiveness of fiscal supervision requires an alternative method to be applied to non-residents, i.e. the minimum taxable base. That is the same as the second aspect of the comparability-issue referred to above.

So from the perspective of justification, the argument is as follows. First, the Court holds that residents and non-residents are comparable (see point (1) above). In response, the Belgian government argues that there is a reason to treat them differently (i.e. a justification ground): there is a lack of information as regards non-residents. The Court dismisses this argument, by pointing out that the necessary information can be obtained by relying on the Mutual Assistance Directive (see point (2) above).

[1712] Opinion of Advocate-General Mengozzi in C-383/05, *Talotta*, § 60-73. The Advocate-General also dismisses the argument that it is impossible to determine the taxable base of a non-resident on the basis of signs and indications because information concerning a non-resident taxpayer's lifestyle and personal and family situation is too general and does not show to what extent it is attributable to activities carried on in Belgium, and to what extent it relates to activities in the country of residence. The Advocate-General points out that such difficulties could also arise in situations involving a resident. More specifically, it is possible that a resident taxpayer's lifestyle and personal and family situation can be attributed to income from several countries, in which case it would prove difficult to identify profits attributable only to activities carried on as a self-employed person in Belgium. So in that respect, residents and non-residents are comparable as well.

[1713] Both in the judgment of the Court (§ 34-37) and in the Opinion of the Advocate-General (§ 84-89)

This illustrates how difficult it is to distinguish elements relating to the comparability-analysis from justification grounds. In particular, point (2) of the analysis (the fact that Belgium can rely on the Mutual Assistance Directive) is both an element of comparability and an element of justification. As regards comparability, the argument is that the Mutual Assistance Directive removes the difference between the situations (i.e. the lack of information as regards non-residents), thus rendering them comparable. As regards justification, the argument is that the Mutual Assistance Directive ensures the effectiveness of fiscal supervision.

This apparent interchangeability can be explained by the fact that justification grounds always relate differently to the subject and the object of comparison (assuming that the justification ground is accepted). Indeed, in order for a justification ground to explain why the subject and object of comparison are treated differently, it is necessary that that justification ground applies exclusively to one of them. Applied to the present case, the Belgian government relied on the justification ground that the lack of information in the case of non-residents endangered the effectiveness of fiscal supervision and therefore justified the different treatment. In order for that justification ground to succeed, it is necessary that it applies exclusively to the subject of comparison (non-residents): if there is a lack of information for both residents and non-residents (or for neither), there is no reason to treat them differently. That is exactly the same as arguing that residents and non-residents cannot be compared because of the lack of information in the case of non-residents. Once again, for the argument to succeed, it is necessary that the lack of information only applies to non-residents. If not, the situations are comparable and treating them differently constitutes discrimination.

Thus, depending on the way one looks at the argument, it can function both as a comparability-argument and a justification ground. At first sight, this distinction might seem entirely academic but that is not the case. As discussed in 1.B.IV, the justification-analysis includes a test of suitability (i.e. the measure must be suitable for the purpose of achieving the desired objective) and a proportionality test (i.e. the measure must not go beyond what is necessary to achieve the objective)[1714]. No such tests are included in the comparability-analysis. Therefore, it is important to distinguish matters relating to comparability from matters relating to justification. This issue will be addressed in detail in 2.F.III.

> The Mutual Assistance Directive, and its (in)ability to ensure the effectiveness of fiscal supervision, has been discussed more often in the justification-test than in the comparability-test. In particular, the ECJ has often dismissed the lack of effective supervision as a justification-ground on the basis that the Directive allows for the possibility to request the necessary information[1715].
>
> A similar argument, which Member States have regularly brought forward since *Bachmann*, is that the Directive is insufficient to ensure the effectiveness of fiscal supervision, with the result that it is justified to refuse certain tax benefits to residents of other Member States. The idea behind this argument is that Article 8(1) of the

[1714] See, for instance, the Opinion of Advocate-General Mengozzi in C-383/05, *Talotta*, § 88: assuming that the Belgian legislation at issue could be regarded as necessary in order to ensure the effectiveness of fiscal supervision, it must also be proportionate to that objective, which implies that *"non-resident taxpayers must be sure of being able to avoid flat-rate taxation by producing the relevant documents or other evidence suitable for demonstrating the real amount of their tax liability."* No such requirement is discussed in the context of the comparability-analysis.

[1715] E.g. C-204/90, *Bachmann*, § 18; C-1/93, *Halliburton*, § 21-22; C-279/93, *Schumacker*, § 43-45; C-55/98, *Vestergaard*, § 26; C-386/04, *Stauffer*, § 50; C-520/04, *Turpeinen*, § 35-37.

Directive[1716] limits the scope of the Directive by providing that it does not require Member States to exchange information if that would be contrary to its legislation or administrative practices (e.g. bank secrecy). The ECJ has traditionally dismissed this argument by pointing out that there is nothing to prevent the Member State in question from requesting the information directly from the taxpayer if the other Member State does not collaborate[1717].

b. Information exchange and third countries

1. FII: the inapplicability of the Mutual Assistance Directive leads to incomparability

In the *FII*-judgment, discussed in 2.E.I.A.b.6.b.7, the U.K. government argued that, where dividend distributing companies were established in third countries, it was more difficult to determine the tax paid in their home State than in a purely EU context. This is similar to the argument raised in *Talotta*, that there was a lack of information as regards non-residents, which explained why the benefits at issue were not extended to them.

In *FII*, however, the comparison is made between two categories of non-residents: non-residents who are established in another Member State and non-residents who are established in a third country. If there is indeed a lack of information as regards the latter category, that might explain why the benefit at issue is not extended to such non-residents. The Court recognizes this possibility: "*It is true that, because of the degree of legal integration that exists between Member States of the Union, in particular by reason of the presence of Community legislation which seeks to ensure cooperation between national tax authorities, such as [the Mutual Assistance Directive], the taxation by a Member State of economic activities having cross-border aspects which take place within the Community is not always comparable to that of economic activities involving relations between Member States and non-member countries*"[1718].

Ultimately, the Court rejected the U.K. government's argument in *FII* (see 2.E.I.A.b.6.b.7) but it acknowledged expressly that the taxation of cross-border transactions within the EU is not always comparable to that of cross-border transactions involving third countries, in

---

[1716] "*This Directive does not impose any obligation upon a Member State from which information is requested to carry out inquiries or to communicate information, if it would be contrary to its legislation or administrative practices for the competent authority of that State to conduct such inquiries or to collect the information sought.*" Before it was amended in 2004 (Directive 2004/56/EC of 21 April 2004), the provision was worded as follows: "*This Directive shall impose no obligation to have enquiries carried out or to provide information if the Member State, which should furnish the information, would be prevented by its laws or administrative practices from carrying out these enquiries or from collecting or using this information for its own purposes.*"

[1717] E.g. C-204/90, *Bachmann*, § 20; C-101/05, *A*, § 58; C-318/07, *Persche*, § 69. See also C-451/05, 11 October 2007, *ELISA*, concerning the French annual 3% tax on immovable property (which was already discussed in Part II, 2.B.V.B.d, in the context of the French Supreme Court's decision of 28 February 1989). That tax was not applicable to legal persons having their place of effective management in France. Additionally, the tax did not apply to legal persons having their management elsewhere if they were entitled to non-discriminatory treatment in France on the basis of a tax treaty or if their State of residence had a tax treaty with France providing for administrative assistance in tax matters. The French/Luxembourg treaty contained a non-discrimination clause and a mutual assistance clause, but that treaty did not apply to Luxembourg holding companies. The ECJ first held that the Mutual Assistance Directive did not apply to the issue because, under Luxembourg domestic law, the Luxembourg tax authorities were unable to obtain themselves information from Luxembourg holding companies. Art. 8(1) of the Directive therefore applied. The ECJ then held that the refusal to grant the exemption was disproportionate to the purpose of preventing tax evasion since the French tax authorities were free to request the necessary information from the taxpayer and, where appropriate, refuse the exemption if that evidence was not supplied.

[1718] C-446/04, *FII*, § 170.

particular because of the lack of information exchange in the latter situation. As a result, justification grounds which would not be accepted in an EU context, particularly the need to ensure the effectiveness of fiscal supervision, might be accepted in a third country-situation[1719].

2. A: FII explained

The ECJ further addressed this point in the *A*-case. At issue was a Swedish measure on the taxation of dividends distributed in the form of shares in a subsidiary. If such dividends were distributed by a Swedish limited liability company, they were exempt from tax in Sweden for a Swedish resident recipient, provided that a number of additional conditions were met. In order to ascertain the fulfilment of some of these additional conditions[1720], the Swedish tax authorities needed to obtain information from the tax authorities of the distributing company's State of residence. The exemption also applied where the distribution of shares was carried out by a foreign company which corresponded to a Swedish limited liability company if it was established in a State within the EEA or in a State with which Sweden had concluded a tax treaty that contained a provision on exchange of information.

Mr A, a Swedish resident taxpayer, owned shares in a Swiss company. The tax treaty between Sweden and Switzerland did not contain a provision on exchange of information[1721]. Therefore, the Swedish tax authorities decided that a distribution of shares held by the Swiss company in its subsidiary to Mr A would not qualify for the exemption. Mr A argued that this denial fell foul of the free movement of capital.

According to a number of intervening governments, the free movement of capital could not be interpreted in the same manner with regard to relations between Member States and third countries as it is with regard to relations between Member States. They argued that the extension of the free movement of capital to relations between Member States and third countries is linked to the completion of economic and monetary union. In contrast, the liberalisation of the movement of capital between the Member States is intended to complete the internal market. Given these different purposes, the free movement of capital requires a different interpretation in both situations. Otherwise, there would be a unilateral liberalisation on the part of the EU, without the EU securing a guarantee of equivalent liberalisation on the part of the third countries concerned and without measures for the harmonisation of national provisions, in particular on direct taxation. Finally, they argued that if the free movement of capital in relation to third countries were interpreted in the same way as between two Member States, the EU would be deprived of the means of negotiating liberalisation with those third countries, since such liberalisation would have already automatically and unilaterally opened up the EU market to those countries. Additionally, the provisions on free movement of capital in the association agreements concluded with third countries often have a more limited scope than that of Article 63 TFEU, which would be meaningless if that provision were as rigorously applicable in relations with third countries as in EU relations[1722].

[1719] C-446/04, *FII*, § 171.
[1720] For instance the condition that all of the parent company's shares in the subsidiary had to be distributed.
[1721] The ECJ also notes that it was apparent from the Protocol accompanying the tax treaty that *"the Swiss delegation considered that the only information that could form the subject of an exchange was that needed in order to ensure proper application of the Convention and that which would prevent improper application of it."* Apparently, Sweden *"took formal note of that declaration and did not seek to include in the Convention any express provision on the exchange of information."* See C-101/05, *A*, 18 December 2007, § 9.
[1722] C-101/05, *A*, 18 December 2007, § 28-30.

The ECJ disagreed. The Court noted that, even if the free movement of capital with third countries pursued other objectives than establishing an internal market[1723], the Member States had chosen to enshrine that principle in the same EC Treaty provision (Article 56(1) EC, which corresponds to the current Art. 63(1) TFEU) and in the same terms for movements of capital taking place within the EU and those relating to relations with third countries. Moreover, all the Treaty provisions on capital and payments show that the Member States considered it necessary to provide safeguard clauses and derogations which apply specifically to the movement of capital to or from third countries, in order to take account of the fact that the objective and the legal context of the liberalisation of the movement of capital differ according to whether third countries are involved[1724]. Finally, apart from these specific derogations and safeguards, the Member States can also rely on the justification grounds provided for in the Treaty or based on the rule of reason.

However, the Court then stresses that the extent to which the Member States are thus authorised to apply certain restrictive measures on the movement of capital *"cannot be determined without taking account of the fact that movement of capital to or from third countries takes place in a different legal context from that which occurs within the Community."* As pointed out in *FII*, the taxation of cross-border transactions within the EU is not always comparable to transactions involving a third country because of the degree of legal integration in the EU (see supra: EU legislation such as the Mutual Assistance Directive seeks to ensure cooperation between national tax authorities). For this reason, it is possible that a Member State will be able to justify a restriction on the movement of capital to or from third countries in circumstances where that justification ground would not be valid in a situation within the EU[1725].

As to the measure at issue in *A*, the Swedish government argued that the refusal to grant the exemption where dividends were paid by a company established in a third country with which Sweden has not concluded a tax treaty providing for the exchange of information was justified by the need to guarantee the effectiveness of fiscal supervision. With regard to a third country, the Swedish tax authorities cannot have recourse to the mutual assistance between competent authorities provided for by the Mutual Assistance Directive. Moreover, the tax treaty did not contain an exchange of information clause comparable to Article 26 OECD MC. Even if the taxpayer has the information necessary to demonstrate that the requirements for exemption are satisfied, the tax authorities are still required to assess the value of the evidence provided, which would be impossible without the power to seek cooperation from the competent authorities of the State of establishment of the distributing company.

In response to this argument, Mr A relied on the case law referred to above, in which the ECJ has held that a Member State cannot justify its refusal to grant a tax advantage by relying on the fact that it may be impossible to seek cooperation from another Member State in conducting inquiries or collecting information: even if it proves difficult to verify the

[1723] Such as, in particular, the objective of ensuring the credibility of the single EU currency on world financial markets and maintaining financial centres with a world-wide dimension within the Member States.

[1724] C-101/05, *A*, 18 December 2007, § 31-33, referring to Art. 57(1) (the grandfather-clause), 59 (which allows the Council to take safeguard measures in exceptional circumstances where movements of capital to or from third countries (threaten to) cause serious difficulties for the operation of economic and monetary union), 60(1) (which authorises certain measures to be taken as regards capital movements where specific conditions are met) and 60(2) EC (which allows a Member State under specific conditions to take unilateral measures against a third country with regard to capital movements and payments). Those provisions correspond to the current Articles 64(1), 66 and 75 TFEU.

[1725] C-101/05, *A*, 18 December 2007, § 36-38.

information provided by the taxpayer, in particular due to the limited nature of the exchange of information provided for by Article 8 of the Mutual Assistance Directive, the tax authorities can always request from the taxpayer the necessary evidence to carry out a correct tax assessment.

The Court disagrees and points out that *"that case-law, which relates to restrictions on the exercise of freedom of movement within the Community, cannot be transposed in its entirety to movements of capital between Member States and third countries, since such movements take place in a different legal context"*.

First, relations between the Member States take place against a common legal background, characterised by the existence of EU legislation, such as the Mutual Assistance Directive, which provides for reciprocal obligations of mutual assistance. Even though the obligation to provide assistance is not unlimited, the Directive has established a framework for cooperation between the competent authorities of the Member States which does not exist between those authorities and the competent authorities of a third country where the latter has given no undertaking of mutual assistance.

Secondly, with regard to the documentary evidence provided by the taxpayer to enable the tax authorities to ascertain whether the requirements under national legislation are satisfied, the EU harmonisation measures on company accounts[1726] which apply in the Member States allow the taxpayer to produce reliable and verifiable evidence on the structure or activities of a company established in another Member State. That is not the case where the company is established in a third country which is not required to apply those EU measures.

The Court therefore concludes that where the legislation of a Member State makes the grant of a tax advantage dependent on satisfying requirements and the compliance with those requirements can be verified only by obtaining information from the competent authorities of a third country, it is legitimate for that Member State to deny that advantage if it proves impossible to obtain information from that third country because it is not under any contractual obligation to provide information.

Commentary

As pointed out earlier, the ECJ has often dismissed the lack of effective supervision as a justification ground on the basis that the Mutual Assistance Directive allows the tax authorities concerned to request the necessary information. That position cannot be transposed to situations involving third countries: since the EU instruments providing for administrative cooperation, in particular the Mutual Assistance Directive, do not apply in such situations, the tax authorities of the Member State in question are not always able to obtain the necessary information[1727]. This is an illustration of the Court's statement in *FII* that justification grounds

[1726] In particular, Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of companies and Seventh Council Directive 83/349/EEC of 13 June 1983 based on the Article 54 (3) (g) of the Treaty on consolidated accounts.
[1727] Arguably, the same is true for the Directive concerning mutual assistance for the recovery of tax claims. That Directive does not apply in situations involving third countries, with the result that it may be justified for a source State to impose a withholding tax on payments made to recipients established in third countries, while not applying such a withholding tax to payments made to resident recipients or to recipients established in another Member State. As discussed in 2.E.I.A.b.7.b, the inapplicability of that Directive in the situation at issue in *Truck Center* should have been taken into account in the justification-test. That is to say, the inapplicability of the Directive could have justified the fact that Belgium imposed a withholding tax on payments made to residents of

which would not be accepted in an EU context, particularly the need to ensure the effectiveness of fiscal supervision, might be accepted in a third country-situation (see supra).

However, the situation is different where the applicable tax treaty with the third country requires that country to provide the relevant information. In such a case, the Member State concerned cannot rely on the fact that there may be a lack of information as regards residents of the third country. Worded in the terms of the *Talotta*-judgment, residents of the third country and residents of another Member State *"are in a comparable situation as regards the means of proof available to establish the taxable base"* (see supra). Once again, this reveals the fine line between comparability and justification: the fact that both categories of non-residents are comparable as regards exchange of information means that the same analysis with respect to the fiscal supervision-justification applies.

Nevertheless, the Court also stresses the importance of the EU harmonisation measures on company accounts. Those measures ensure that the documentary evidence provided by the taxpayer, which enables the tax authorities to ascertain whether the relevant requirements under national legislation are satisfied, is reliable and verifiable. That issue is related to the second line of case law concerning the role of the Mutual Assistance Directive in the context of the fiscal supervision-justification (see supra). More specifically, Member States have tried to argue that, because of its limited scope, the Directive is insufficient to ensure the effectiveness of fiscal supervision, with the result that it is justified to refuse certain tax benefits to residents of other Member States. As pointed out earlier, the ECJ has traditionally dismissed this argument by pointing out that there is nothing to prevent the Member State in question from requesting the information directly from the taxpayer if the other Member State does not collaborate. As a result of that case law, Member States are not allowed to categorically deny tax benefits on the basis that they are unable to obtain sufficient information from the other State[1728]. The taxpayer should always be given the possibility to provide the necessary information. In the *A*-case, the taxpayer argued that the absence of this possibility under Swedish law meant that the measure was disproportionate[1729].

However, the Court points out that, in this context as well, the movement of capital to or from third countries differs from the movement of capital between Member States. In the latter situation, the relevant EU harmonisation measures ensure that the documentary evidence provided by the taxpayer is relevant and verifiable. Since those measures do not apply in situations involving a third country, it may be justified for a Member State to deny a tax benefit without allowing the taxpayer to provide the necessary evidence.

In this respect, the Court's decision in *Geurts-Vogten*, which was given less than two months before *A*, is remarkable. In *Geurts-Vogten*, the ECJ held that the fact that the Mutual Assistance Directive does not apply to inheritance taxes "*cannot justify the categorical refusal to grant the tax benefits in question since the tax authorities could request the taxpayers concerned to provide themselves the evidence which the authorities consider*

---

another Member State, while refraining from imposing such a withholding tax on payments made to Belgian residents. Unfortunately, however, the Court took this argument into account in the comparability-test.

[1728] The *A*-judgment is not entirely conclusive as to the extent of the information obligation. All that is clear, is that the obligation must encompass the information necessary to verify compliance with the requirements imposed by national law in order to enjoy the tax advantage. Accordingly, the extent of this criterion should be assessed on a case-by-case basis, taking into account the requirements imposed by the national legislation at issue. See also N. BAMMENS, "KBC: onduidelijkheid blijft over DBI-overschotten bij niet-EU dividenden", *Fisc. Int.* 2009, 307, 4.

[1729] C-101/05, *A*, 18 December 2007, § 57.

necessary to be fully satisfied that those benefits are granted only where the jobs in question fulfil the criteria set out under national law"[1730].

That is difficult to reconcile with the Court's position in *A*. Even though there are no EU harmonisation measures in the field of inheritance tax that allow the tax authorities concerned to verify the documentary evidence provided by the taxpayer, the Court nevertheless requires the Member State to allow the taxpayer to provide the necessary evidence. It is unclear why the Court's position with respect to inheritance taxes differs from its position with respect to capital movements to and from third countries. In neither of those situations is there a legal framework for administrative cooperation, nor are there harmonisation measures to ensure that information provided by the taxpayer is verifiable and relevant[1731]. The result of this divergent approach is that a taxpayer is unable to provide the relevant evidence in situations where the Mutual Assistance Directive does not apply *ratione territoriae* (because a third country is involved), whereas a taxpayer is able to provide such evidence in situations where the Mutual Assistance Directive does not apply *ratione materiae* (e.g. in the field of inheritance taxes) even though there are no harmonisation measures governing that evidence.

The Court has since confirmed both of these positions: in *Bauer*, it repeated the *Geurts-Vogten* argument that the inapplicability *ratione materiae* of the Directive does not mean that the fiscal supervision-justification succeeds, because the tax authorities can always request the necessary information from the taxpayer[1732]. In *Persche*[1733], on the other hand, the Court has repeated its position taken in *A* that it is legitimate for a Member State to deny a tax advantage as regards transactions involving a third country if it proves impossible to obtain the necessary information from that country because it is under no international obligation to cooperate. In this context, the Court does not refer to the possibility for the tax authorities to request the necessary information from the taxpayer[1734].

3. Commission v Netherlands: confusion concerning EEA countries

There may be some confusion with regard to cases involving EEA countries. *Commission v Netherlands* concerned the taxation in the Netherlands of outbound dividends as regards the EEA countries Iceland and Norway[1735]. As discussed in 2.E.I.A.b.6.c.3, the Court held the Dutch system concerning outbound dividends to be incompatible with the fundamental freedoms in *Amurta*. The Dutch system was amended after *Amurta* in order to remove the

---

[1730] C-464/05, *Geurts-Vogten*, 25 October 2007, § 28

[1731] See also S. HEMELS, "References to the Mutual Assistance Directive in the case law of the ECJ: a systematic approach", *European Taxation* 2009, 586; N. BAMMENS, "KBC: onduidelijkheid blijft over DBI-overschotten bij niet-EU dividenden", *Fisc. Int.* 307, 4-5.

[1732] C-360/06, *Bauer*, 2 October 2009, § 41.

[1733] See also C-201/05, *Test Claimants CFC*, 23 April 2008, § 95-96 and C-194/06, *Orange European Smallcap,* 20 May 2008, § 89-90.

[1734] C-318/07, *Persche*, 27 January 2009, § 70. On the other hand, the Court in *Persche* expressly refers to this possibility for transactions involving another Member State (C-318/07, *Persche*, § 60). So *Persche* seems to imply that a taxpayer who makes a gift to a charitable body in another Member State should always be given the possibility to provide the relevant information, while he is not necessarily entitled to this possibility as regards gifts made to charitable bodies in third countries (see also infra, 2.E.I.A.b.10.b). Since the Court refers to *A* when arriving at this conclusion, it seems that this distinction is due to the fact that the EU measures that allow the taxpayer to produce reliable and verifiable evidence on the nature of the recipient of the payment do not apply when the gift is made to a body established in a third country. For the sake of legal certainty, however, it might be preferable for the Court to indicate if, and to what extent, bilateral instruments concerning information exchange could also allow the taxpayer to produce reliable and verifiable evidence.

[1735] C-521/07, *Commission v Netherlands*, 11 June 2009.

discrimination. Following this amendment, dividends of a Dutch company paid to another Dutch company or to a company established another EU Member State were exempt from Dutch source tax if the recipient company held at least 5% of the capital of the distributing company.

Since the amendment only concerned recipients of dividends established in the EU, recipients of dividends established in EEA countries were entitled to a reduction of source tax only insofar as this was provided for in the applicable tax treaty. In the case at issue, the tax treaty between the Netherlands and Iceland provided for an exemption from source tax on dividends in the case of a holding of at least 10% in the Dutch company while the tax treaty between the Netherlands and Norway required a holding of at least 25%.

The Court held that this distinction between, on the one hand, companies established in the Netherlands or another EU Member State and, on the other hand, companies established in Iceland and Norway, could constitute a restriction of the free movement of capital contrary to Article 40 of the EEA Agreement[1736] if those categories of recipients were comparable.

According to the Dutch government, that was not the case. They pointed out that a number of conditions applied to recipients established in other EU Member States in order to qualify for the exemption, i.e. having a certain legal form, being subject to a tax on profits and being the final beneficiary of the dividends. Compliance with those conditions could easily be verified between Member States, given the applicability of the Mutual Assistance Directive. That was not the case for recipients of dividends established in Iceland or Norway, since the Mutual Assistance Directive did not apply. The Dutch government then pointed out that the tax treaties concluded with Iceland and Norway were not legal instruments of the EU and did not allow a Member State or the Commission to demand before the ECJ that the resulting obligations be performed. Accordingly, there was no binding rule enabling the Dutch tax authorities to obtain information to verify whether the conditions under domestic law were met[1737].

The ECJ dismissed this argument, holding as follows: *"even if such a difference in the system of legal obligations of the States in question in the tax area, in comparison with those of the Member States of the Community, is capable of justifying the […] Netherlands in making the benefit of exemption from deduction at source of the tax on dividends subject, for Icelandic and Norwegian companies, to proof that those companies do in fact fulfil the conditions laid down by Netherlands legislation, it does not justify that legislation in making the benefit of that exemption subject to the holding of a higher stake in the capital of the distributing company."*

[1736] *"Within the framework of the provisions of this Agreement, there shall be no restrictions between the Contracting Parties on the movement of capital belonging to persons resident in EC Member States or EFTA States and no discrimination based on the nationality or on the place of residence of the parties or on the place where such capital is invested. […]"*

[1737] C-521/07, *Commission v Netherlands*, 11 June 2009, § 27-29 and 44-46. This argument balances on the line between comparability and justification. The Dutch government tries to demonstrate that recipients established in Iceland and Norway are not comparable to recipients established in EU Member States. The reason for this incomparability is that the Mutual Assistance Directive applies to the latter category of recipients but not to the former. Since information from the recipient's State of residence is required in order to verify compliance with the conditions provided for in national law, the (in)applicability of the Directive is a relevant difference. The result of this incomparability is that justification grounds which failed with respect to dividend recipients established in EU Member States, in particular the effectiveness of fiscal supervision, may succeed with respect to recipients established in a country of the EEA. And, as pointed out earlier, the reason why that justification ground may succeed in the latter case is that Mutual Assistance Directive does not apply (see supra).

The Court therefore dismisses the justification ground because the inapplicability of the Mutual Assistance Directive was irrelevant for the requirement of holding a higher stake in the capital of the distributing company. Unlike the other conditions provided for in national law in order to be entitled to the exemption, i.e. having a certain legal form, being subject to tax on profits and being the final beneficiary of the dividends paid, it was not necessary for the Dutch tax authorities to verify compliance with the requirement of a higher shareholding. According to the Court, the Dutch government did not demonstrate that the fact that the recipient had a stake of less than 10% or 25% in the distributing company's capital could have any impact on the risk that the Dutch tax authorities might be given erroneous information as regards the tax treatment of companies established in Iceland and Norway.

In other words, only information that was relevant for the tax treatment of the recipient companies was relevant for determining whether the measure was justified on the basis of the fiscal supervision-argument. And because the minimum holding of 10% or 25%, which did not apply to companies established in the Netherlands or in EU Member States, was irrelevant for that tax treatment, the justification argument failed.

For the present discussion, the most interesting aspect of this judgment is the first part of the Court's statement quoted above: *"even if such a difference in the system of legal obligations of the States in question in the tax area, in comparison with those of the Member States of the Community, is capable of justifying the […] Netherlands in making the benefit of exemption from deduction at source of the tax on dividends subject, for Icelandic and Norwegian companies, to proof that those companies do in fact fulfil the conditions laid down by Netherlands legislation […]"*. Thus, the Court does not repeat its argument from *A* that it may be legitimate for a Member State to deny a tax advantage if compliance with the requirements for the grant of that advantage can be verified only by obtaining information from a third country, and that third country is not under any contractual obligation to provide information. Here, the Court only notes that the difference as to the existing legal obligations may be capable of justifying the Netherlands in making the tax advantage **subject to proof** that the conditions are met.

On the basis of that statement, it has been argued that regarding EEA countries, or at least regarding Norway and Iceland, the taxpayer must be allowed to prove that he fulfils the conditions for a certain tax benefit, even though the Mutual Assistance Directive does not apply to those countries[1738]. The Court's statement in itself, however, does not explain why the Court would take a different position with respect to these EEA countries as it did with respect to other third countries. The Court does not say what this possibility of making the advantage 'subject to proof' entails, i.e. whether this implies that the taxpayer is allowed to prove that the conditions are met. And that issue was not conclusive for the Court's argument: all that mattered, in the end, is that the requirement as to the minimum shareholding was irrelevant for the tax treatment of the recipient company[1739].

Moreover, the argument of the Dutch government that there was "no binding rule" enabling the Dutch tax authorities to obtain the necessary information to verify whether the conditions were met, was not entirely convincing. Both the Dutch/Icelandic tax treaty and the Dutch/Norwegian tax treaty provided that the competent authorities of the contracting States

[1738] S. HEMELS, *o.c.*, 586.

[1739] But see hereafter, on the fact that certain Directives must be transposed by EEA countries and the resulting differences as regards information provided by the taxpayer.

exchanged "*such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the contracting States concerning taxes covered by the Convention*"[1740]. Even though the Court does not mention this in its judgment, it is clear that there was a binding rule that imposed the obligation on Iceland and Norway to exchange the necessary information. This difference with the tax treaty between Sweden and Switzerland which applied to the facts of *A* (see supra) may also explain why the Court did not repeat the arguments it set out in that case.

4. Commission v Italy[1741]

The Court was given a chance to clarify its position with respect to EEA countries in a 2009 case concerning the Italian tax regime on outbound dividends. Since dividends paid by a resident company to another resident company were exempt from tax in the amount of 95% while dividends paid by a resident company to a non-resident company were subject to a 27% withholding tax, the measure was clearly discriminatory[1742]. The Court addressed the matter from the perspective of the free movement of capital, both under the EC Treaty and the EEA Treaty.

The Italian government argued that the distinction was justified on the basis of the fight against tax evasion. With respect to Art. 56 EC (current Art. 63 TFEU), the Court dismissed this argument. It recalled that such an argument could only be acepted if it concerned purely artificial arrangements set up to circumvent tax law, with the result that general presumptions of tax avoidance or evasion were insufficient to justify a discriminatory measure. In the present case, all dividends paid to companies established in other Member States were made subject to a less favourable tax regime. Accordingly, the measure could not be justified on the basis of the fight against tax evasion since it was not only targeted at purely artifical arrangements set up to circumvent tax law. Moreover, the Court noted that Italy could rely on the Mutual Assistance Directive in order to obtain from the competent authorities of another Member State all the information necessary to correctly establish the amount of tax due[1743].

With respect to Article 40 EEA, the Court reached a different conclusion[1744]. It first referred to *A*, noting that the case-law on the freedom of movement within the EU cannot be transposed in its entirety to movements of capital between Member States and non-member countries, "*since such movements take place in a different legal context*". The Court then observed that the framework of cooperation between the competent authorities of the Member States established by the Mutual Assistance Directive did not exist between those Member States and the competent authorities of a non-Member State when the latter State has not entered into any undertaking of mutual assistance. According to the information provided to the Court, Italy did not have an agreement on the exchange of information with Liechtenstein, nor did Italy's tax treaties with Iceland and Norway contain provisions laying down an obligation to provide such information[1745]. For that reason, the Court held that the Italian

[1740] Article 28 of the 1997 treaty between Iceland and the Netherlands and Article 27 of the 1990 treaty between the Netherlands and Norway.
[1741] C-540/07, *Commission v Italy*, 19 November 2009.
[1742] Non-residents were entitled to a refund of four ninths of that sum on application, but that was obviously insufficient to remove the disadvantage.
[1743] C-540/07, *Commission v Italy*, § 57-61.
[1744] C-540/07, *Commission v Italy*, § 68-73.
[1745] The information provided by Italy to the Court seems to be incorrect: both Article 27 of the 1985 treaty between Italy and Norway and Article 27 of the 2002 treaty between Italy and Iceland provide that the competent authorities of the Contracting States exchange the information that is necessary for applying the tax

legislation at issue was justified in relation to the EEA Treaty on the basis of the need to combat tax evasion. Moreover, the measure was appropriate to ensure the realisation of that objective and did not go beyond what was necessary to attain it.

This decision illustrates that the starting point as regards the influence of information exchange on the comparability-test should be the same in situations involving EEA countries and situations involving other third countries: the Court clearly transposes its *A*-argument to EEA countries, pointing out that the different legal context (in particular the absence of obligations pertaining to information exchange) meant that situations involving EEA countries were not comparable to situations involving EU Member States as regards measures to combat tax evasion (and the corollary necessity to obtain information).

However, two remarks are in order. First, the Court's conclusion that the Italian measure was justified in relation to the EEA Treaty on the basis of the need to combat tax evasion is open to criticism. It is true that the circumstances as regards the exchange of information differ between intra-EU situations and situations involving EEA countries. Yet, the Court has traditionally held that a national measure intended to prevent tax evasion should only target wholly artificial arrangements intended to circumvent national law[1746]. In *Commission v Italy*, the Court refers to that criterion when it tests the national measure against the EC Treaty (see supra), but not when it holds that measure against the light of the EEA Agreement. There is no apparent reason why that criterion should be disregarded in situations involving third countries, and it is unlikely that the Italian measure at issue would pass the test[1747].

Secondly, and more importantly, there is a significant difference between EEA countries and other third countries. In particular, Annex XXII to the EEA Agreement requires the EEA countries to transpose a number of Directives into their domestic law, including Fourth Council Directive 78/660/EEC on the annual accounts of certain types of companies and Seventh Council Directive 83/349/EEC on consolidated accounts. That is not the case for other third countries. As a result, there may be a difference between the situations as regards the possibility for taxpayers to produce evidence in situations where there is no legal framework on information exchange or where that framework is insufficient. Accordingly, if the tax authorities of a Member State are required to obtain information in order to ascertain whether the conditions for granting a tax benefit under national law are fulfilled, and the Directives referred to above[1748] lay down measures to ensure that evidence provided by a taxpayer is reliable and verifiable (e.g. company accounts), that Member State cannot exclude a priori the possibility for the taxpayer to produce such evidence in order to obtain the tax advantage in situations involving EEA countries[1749].

---

treaty or the domestic laws and to prevent fiscal evasion. If the Court had taken those provisions into account, Italy's justification argument would most likely have been dismissed.

[1746] E.g. C-264/96, *ICI*, § 26.

[1747] See also D. WEBER, "Comments on Commission v Italy", *Highlights and Insights* 2010, 2, 53-54.

[1748] Or other Directives which contain such measures and which, according to the EEA Agreement, must be transposed by EEA countries.

[1749] Nevertheless, the Court took a slightly different approach in C-72/09, *Rimbaud*, 28 February 2010. The case concerned the French 3% tax on immovable property, which has already been referred to earlier (see supra, on *ELISA*), in relation to an EEA State (Liechtenstein). The Court first recalls its conclusion reached in *ELISA*, that the French regime restricted the free movement of capital and that it was disproportionate to the need to combat tax avoidance since, even though the Mutual Assistance Directive did not apply due to Article 8(1), the French tax authorities were free to request the necessary information from the taxpayer. However, the Court then refers to *A* and points out that that position cannot be transposed entirely to situations involving third countries. Since neither the Mutual Assistance Directive, nor a similar instrument on the exchange of information applied in *Rimbaud*, France was unable to obtain the necessary information from the Liechtenstein tax authorities. As to the

5. Conclusion

The comparison at issue here is between transactions taking place within the EU and transactions involving a third country. The Court's basic position in this regard is that the situations are not comparable for two reasons. Those two reasons concern two different aspects of the Court's traditional case law on exchange of information and should not be confused. The first aspect concerns the possibility for a Member State to obtain from another State the information necessary to apply its domestic law. The second aspect concerns the possibility for the taxpayer to provide the necessary information himself if there is no instrument providing for exchange of information or if the instrument in question does not allow the tax authorities to obtain the necessary information.

In the context of transactions taking place within the EU, the Court has traditionally dismissed justification arguments pertaining to the lack of effective fiscal supervision on the basis that Member States are able to rely on the Mutual Assistance Directive to obtain the necessary information. Moreover, the Court has consistently dismissed the argument that, due to Article 8, the scope of that Directive is too narrow by pointing out that the taxpayer should always be given the possibility to produce the necessary evidence himself. The latter point should be seen in the context of Union measures that ensure the tax authorities of the Member State concerned that the documentary evidence provided by the taxpayer is reliable and verifiable (such as the harmonisation measures on company accounts).

Those arguments cannot be transposed entirely to third countries. Since the Mutual Assistance Directive does not apply to transactions involving those countries, it is necessary in each case to ascertain whether a similar legal instrument applies that ensures that the tax authorities of the Member State concerned are able to obtain the information necessary to apply the national tax legislation. If there is no such instrument or if the instrument in question does not cover all the necessary information, it must be verified whether there is a legal instrument that ensures the tax authorities of the Member State concerned that the documentary evidence provided by the taxpayer is reliable and verifiable. If such an instrument applies, the taxpayer should always be given the possibility to produce the necessary evidence himself. However, since there is no legal instrument that allows the tax authorities of the Member State concerned to obtain the necessary information, it is unlikely that there is an instrument that ensures the

---

conclusion reached in *ELISA* that the taxpayer should be given the opportunity to provide the necessary information himself, the Court notes that that conclusion does not apply to the situation of a company established in Liechtenstein because, even though the Mutual Assistance Directive did not apply in *ELISA* either due to Article 8(1), *"the regulatory framework is quite different."* In particular, it was only by way of derogation that Article 8(1) of the Directive provided for an exception to the exchange of information. And since it concerned a derogation, it had to be narrowly construed. In that regulatory framework of the Directive, the possibility for the taxpayer to provide the necessary information, as it was recognized in *ELISA*, was intended to prevent the limit which Article 8 imposed on the general system for the exchange of information, from acting to the detriment of the taxpayer. The Court then holds: *"Although, therefore, that possibility is based on the existence of a general system for the exchange of information, as introduced by Directive 77/799,* ***and accordingly dependent on such a system****, the existence of a right of that kind cannot be recognised in the case of a taxpayer in circumstances such as those of the case before the referring court, which are characterised by the lack of any obligation on the tax authorities of the Principality of Liechtenstein to lend assistance"* (C-72/09, *Rimbaud*, § 50, emphasis added). As a result, the Court held that the French regime was justified in relation to EEA States. However, it is not clear to me why the possibility for a taxpayer to provide the necessary information is dependent on the existence of a general system for the exchange of information. Such a possibility is only relevant where there is no system for the exchange of information or where that system does not apply. In my opinion, the possibility for a taxpayer to provide the necessary information should only depend on the question whether the tax authorities are in a position to verify the information so provided (see supra).

reliability of evidence provided by the taxpayer. In such a situation, it is not contrary to the free movement of capital to disallow the tax benefit without allowing the taxpayer to produce the necessary evidence.

The situation is slightly different for transactions involving EEA countries. Once again, the Mutual Assistance Directive does not apply to transactions involving those countries, with the result that it is necessary in each case to ascertain whether there is a similar legal instrument applicable that ensures that the tax authorities of the Member State concerned are able to obtain the information necessary to apply the national tax legislation[1750]. On the other hand, certain relevant Directives, particularly the Fourth and Seventh Council Directive, must be transposed by EEA countries, with the result that the possibility for the taxpayer to provide information himself is the same as in the context of transactions taking place within the EU, insofar as those Directives are relevant for the information necessary to apply the national legislation.

9. The influence of tax treaties on the comparability-test

a. The D-Case

1. The Court's decision

The most important aspect of the *D*-case, the facts of which were set out in 2.E.1.A.b.1.a.9, concerns the influence of tax treaties on the comparability-test. According to Mr D, he was being discriminated against **as compared to Belgian residents**, because the Netherlands had granted entitlement to the allowance to Belgian residents under a tax treaty. Article 25(3) of the Belgian/Dutch tax treaty provided that *"individuals resident in one of the contracting States are entitled in the other to the personal allowances, concessions and reductions which are granted by the latter to its own residents on account of civil status or family responsibilities"*[1751]. As a result, a Belgian resident in a position similar to that of Mr D would be entitled to the allowance in the Netherlands. Since all other circumstances were the same (i.e. there was no wealth tax in Belgium either), Mr D argued that this difference in treatment was discriminatory.

While Mr D acknowledged that differences in treatment resulting from the allocation of taxing powers between Member States were acceptable, he submitted that the grant of the allowance to Belgian residents was not the result of such allocation. Secondly, he contended that the treatment accorded by the Netherlands to Belgian residents did not reflect reciprocal treatment accorded to residents of the Netherlands by Belgium, since Belgium did not impose a wealth tax and therefore did not grant an allowance to residents of the Netherlands who owned a property in Belgium.

> In his Opinion, Advocate-General Colomer agreed with this latter point. The Advocate-General first points out that, as a result of the tax treaty between Belgium and the Netherlands, *"Netherlands law deterred Germans from investing their savings in the Netherlands, as compared with people living in Belgium."* Referring to Art. 293 EC and *Gilly*, he then observes that Member States are free to conclude tax treaties in order to avoid double taxation and that disparities resulting from the allocation of

[1750] In that respect, reference should be made to the recent increase in tax information exchange agreements (TIEAs) signed between Member States and non-Member States (including EEA countries).

[1751] The interpretation of that clause was discussed in Part II, 2.D.III.D.

taxing powers in such a treaty go beyond the scope of the Treaty freedoms. According to the Advocate-General, the purpose of the Member States' competence to enter into tax treaties *"is to allocate taxation powers, with the result that, where there is nothing to share out, the [tax treaty] becomes meaningless."* Since Belgium did not impose a wealth tax, Article 25(3) of the Belgian/Dutch tax treaty went beyond that purpose of allocating taxing powers. Instead, it was *"a mere privilege for which no consideration is given and for which there is no reciprocal basis, and the test of its Community compatibility must therefore be much more rigorous."* Consequently, he concluded that the difference in treatment between German and Belgian residents fell foul of the free movement provisions[1752].

The Advocate-General's position is open to criticism. The fact that Belgium does not impose a wealth tax does not mean that Art. 25(3), to the extent that it refers to wealth tax allowances, is meaningless or becomes a non-reciprocal privilege 'for which no consideration is given'. A tax treaty should be examined globally in order to take account of its inherent balance. The fact that Belgium does not grant a wealth tax allowance to residents of the Netherlands identical to the wealth tax allowance which the latter State extends to Belgian residents does not mean that the extension is a non-reciprocal privilege. A tax treaty is always the result of a bargaining process between the two Contracting States, where they ultimately strike a balance and mutually grant concessions. The reciprocity of a tax treaty does not simply mean that every benefit which State A grants to State B residents should also be granted in an identical manner by State B to State A residents. Instead, every benefit granted by a Contracting State contributes to an intricate balance shaped by the give-and-take nature of the negotiation process. That is what the concepts of 'reciprocity' and 'the balance of a tax treaty' refer to in this context (see infra).

Moreover, tax treaties are not solely intended to allocate taxing powers with a view to avoiding double taxation. They also seek to reduce source taxes and to ensure legal certainty and a minimum standard of treatment for taxpayers in the other contracting State[1753]. The latter point is of particular importance here, since Art. 25(3) of the treaty is a non-discrimination provision with the very specific objective of extending person-related allowances to residents of the other contracting State[1754]. Clearly, that provision is not intended to alleviate double taxation by allocating taxing powers. Yet, it contributes to the overall balance of the treaty and can therefore not be separated from the remainder of the treaty (see infra).

The Court first distinguishes the case at issue from *Gilly*: *"the main proceedings do not […] relate to the consequences of allocating powers of taxation in relation to nationals or residents of Member States that are party to a convention, but are concerned with drawing a comparison between the situation of a person resident in a State not party to such a convention and that of a person covered by the convention"*[1755]. What is thus at stake is the comparison between two types of non-residents: on the one hand, non-residents who are covered by a tax treaty and, on the other hand, non-residents who are not covered by that tax treaty. The Court holds, first, that the scope of a bilateral tax treaty is limited to the persons referred to in it. However, there are situations where the benefits under a bilateral treaty may

[1752] Opinion of Advocate-General Colomer in C-376/03, *D*, 26 October 2004, *ECR* 2005, I-05821, § 76-83. As will be pointed hereafter, the Court disagreed and held that Art. 25(3) of the tax treaty could not be regarded as a benefit separable from the remainder of the treaty, but was an integral part thereof and contributed to its overall balance.
[1753] N. BAMMENS and L. DE BROE, "Treaty shopping and avoidance of abuse", in M. LANG, a.o. (eds.), *Tax treaties: building bridges between law and economics*, Amsterdam, IBFD, 2010, 53.
[1754] See Part II, 2.D.III.D.
[1755] C-376/03, *D*, § 53.

be extended to a resident of a Member State which is not a party to that treaty. Referring to *Saint Gobain*, the Court consequently submits that, in the case of a tax treaty concluded between a Member State and a non-Member State, the national treatment principle requires the Member State which is party to the tax treaty to grant to PEs of non-resident companies the benefits provided for by that treaty on the same conditions as those which apply to resident companies. In such a case, the non-resident taxpayer having a PE in the Member State is comparable to a taxpayer resident in that State (see 2.E.I.A.a.1.e).

However, the situation at issue in *D* was different, as Mr D was not being compared to a resident of the Netherlands but to another non-resident who received special treatment under a tax treaty (i.e. a resident of Belgium). In that respect, the Court stresses that *"the fact that [the] reciprocal rights and obligations [of Articles 24 and 25(3) of the Belgian/Dutch treaty] apply only to persons resident in one of the two Contracting Member States is an inherent consequence of bilateral double taxation conventions. It follows that a taxable person resident in Belgium is not in the same situation as a taxable person resident outside Belgium so far as concerns wealth tax on real property situated in the Netherlands. A rule such as that laid down in Article 25(3) of the Belgium-Netherlands Convention cannot be regarded as a benefit separable from the remainder of the Convention, but is an integral part thereof and contributes to its overall balance"*[1756]. Put briefly, the existence of the reciprocal rights and obligations – which are inherent in the tax treaty and cannot be regarded as benefits separable from the remainder thereof – renders the different categories of non-residents incomparable. Bilateral tax treaties differ from one another and are the result of a unique balance between the interests of the contracting States. As a result of this unique nature, a taxpayer governed by one tax treaty is not comparable to a taxpayer governed by another tax treaty – assuming that the provision in question cannot be regarded as a benefit separable from the remainder of the tax treaty, but is an integral part thereof and contributes to its overall balance[1757].

2. Commentary

The problem arising in the *D*-case reveals the subtle interplay between the comparability of two situations and the existence of a disadvantage. In the first question in *D* (which was discussed in 2.E.I.A.b.1.a.9), the division between comparability and disadvantage was clear-cut. The disadvantage at issue was the difference in treatment between Mr D and a resident of the Netherlands: domestic tax law in the Netherlands granted a tax benefit to residents, but did not grant the same benefit to non-residents such as Mr D. By applying the *Schumacker*-doctrine, the ECJ decided that Mr D was not comparable to a resident of the Netherlands. As a result, the disadvantage was not contrary to the free movement provisions.

In contrast, the second question concerned the comparison of Mr D with a resident of Belgium. Here, the distinction between comparability and disadvantage is less clear. Once again, the disadvantage that challenged by Mr D was the fact that he could not enjoy the tax benefit. However, in the comparison with a Belgian resident, the difference in treatment between both taxpayers (and, thus, the disadvantage contested by Mr D) was that the tax

[1756] C-376/03, *D*, § 61-62.

[1757] As a side note, one could wonder why the ECJ is so careful not to upset the 'overall balance of a tax treaty', while it is less concerned with the global cohesion of domestic tax systems. Perhaps because tax treaties affect the allocation of taxing powers, which – as is clear from *Gilly* – is beyond the Court's grasp, whereas the design of domestic tax systems (and the resulting cohesion) is the result of the exercise of the taxing powers so allocated. On the question whether a tax treaty provision can ever really be separated from the remainder of the treaty, see infra.

treaty between Belgium and the Netherlands granted the benefit to the Belgian resident, whereas Mr D could not enjoy that benefit. So the difference in treatment was due to the tax treaty. When testing whether the situations were comparable, the Court observes that Mr D cannot be compared to a resident of Belgium because the reciprocal rights and obligations of Articles 24 and 25(3) of the tax treaty apply only to residents of the contracting State. In other words, the tax treaty provision which causes the disadvantage at the same time renders the situations incomparable. The implications of this entanglement will be addressed below.

In his opinion in the *D*-case, Advocate-General Colomer observed that the case at issue was identical to *Saint Gobain* and *Gottardo*[1758], the sole difference being that the two latter cases concerned agreements with non-Member States, whereas the agreement at issue in *D* was between the Netherlands and Belgium[1759]. *Gottardo* concerned a bilateral social security convention between Italy and Switzerland. Mrs Gottardo, who was born in Italy but had the French nationality following her marriage, claimed, for the purposes of fixing the amount of her retirement pension in Italy, that not only periods of insurance in Italy and France but also contributions paid in Switzerland should be taken into account. She invoked the Italian-Swiss social security convention which, for the calculation of pensions, recognised periods worked by Italians in Switzerland. In other words, Mrs Gottardo requested national treatment in Italy in order to invoke the provisions of the Italian-Swiss social security convention[1760]. *Saint Gobain*, the facts of which were discussed in 2.E.I.A.a.1.e, concerned the entitlement of a French company's PE in Germany to benefits laid down in tax treaties which Germany had concluded with third countries.

In *Gottardo*, the Court held that *"when a Member State concludes a bilateral international convention on social security with a non-member country which provides for account to be taken of periods of insurance completed in that non-member country for acquisition of entitlement to old-age benefits, the fundamental principle of equal treatment requires that that Member State grant nationals of other Member States the same advantages as those which its own nationals enjoy under that convention unless it can provide objective justification for refusing to do so"*[1761]. In *Saint Gobain*, the Court decided that the PE of the French company was comparable to a German company and was therefore entitled to the same treaty benefits.

In his Opinion in the *D*-case, the Advocate-General stated that the 'sole difference' between *Gottardo* and *Saint Gobain* on the one hand and *D* on the other hand (i.e. the fact that, in the first two cases, the country with which the agreement had been entered into was a non-Member State) was not *"sufficient to produce a different outcome"*. As a result, the A.-G. held that Mr D was comparable to a Belgian resident, which meant that Mr D should be entitled to the advantages conferred to Belgian residents by the Belgian/Dutch tax treaty[1762].

[1758] C-55/00, *Elide Gottardo v Istituto nazionale della previdenza sociale*, *ECR* 2002 I-00413, 15 January 2002.

[1759] Advocate-General Colomer's Opinion in C-376/03, *D*, 26 October 2004, *ECR* 2005, I-05821, § 89-91.

[1760] The Advocate-General could also have referred to C-466/98, *Open Skies* of 5 November 2002. At issue in that case were the bilateral aviation agreements between the U.S. and certain EU Member States which were being renegotiated according to a more liberal model agreement (the 'open skies' agreement). According to the ECJ, the restriction of those benefits to the companies resident in the contracting States violated the fundamental freedoms. As a result, the Member States involved were not allowed to contract with the U.S. to carve out flying routes in bilateral agreements which restricted benefits to national air carriers. At the time, it was suggested that the *Open Skies*-judgment could have important implications on the application of tax treaties concluded by EU Member States: A. CRAIG, "Open Your Eyes: What the Open Skies Cases Could Mean for the U.S. Tax Treaties with the EU Member States", *Bull. IBFD* 2003, 63-74.

[1761] C-55/00, *Gottardo*, § 34.

[1762] § 93-95 of the Opinion.

So according to the A.-G., the only element that distinguishes *D* from *Saint Gobain* and *Gottardo* is the fact that *D* takes place in a purely 'European' context. However, there is a more important distinction to be drawn, a distinction which might explain why the Court eventually decided *D* differently from those two cases (and differently from the solution proposed by the Advocate-General). In *Saint Gobain* and *Gottardo*, the comparison was made between a non-resident (in *Saint Gobain*) or a non-national (in *Gottardo*) and a resident or a national, respectively. In other words, the comparison in both cases was between the subject of comparison and an internal situation (i.e. a vertical comparison). In both cases, the internal situation was entitled to certain benefits under a treaty concluded with a third State. As the subject of comparison was comparable to the internal situation, the ECJ decided in both cases that the treaty benefits had to be extended to the subject of comparison. In *D*, by contrast, the comparison was between a non-resident and another non-resident (i.e. a horizontal comparison). As the latter non-resident was entitled to certain treaty benefits, the question arose as to whether both categories of non-residents were comparable. For the reasons set out above, the ECJ decided that both categories could not be compared.

In fact, deciding that the two categories of non-residents are comparable would imply an incorporation of a most favoured nation-principle in the Treaty freedoms. The Advocate-General was well aware of this possibility, but he observed that *"in triangular situations such as that in the main proceedings, the position of the taxpayer in the taxing State can be defined on the basis not only of the most-favoured-nation clause but also of the fact that there is a restriction on free movement. The taxpayer will seek, as D. is doing, to have the scope of the agreement covering residents in Belgium extended to him, and that claim can be formulated by reference to a restriction on the free movement of capital if the heavier tax burden and adverse consequences are regarded as contrary to Community law. In short, accepting reciprocal obligations to another Member State which limit the freedom of movement of the nationals of European non-member countries is contrary to Community law"*[1763]. In other words, the Advocate-General reaches his conclusion not on the basis of an MFN-principle, but on the basis of the free movement provisions, which prohibit a 'restriction' such as that at issue in *D*. However, the effect of such a broad interpretation of the free movement provisions is precisely that they would be extended to include an implicit MFN-clause. It is therefore unclear why the A.-G. makes a distinction between deciding the matter on the basis an (implicit) MFN-clause and deciding it on the basis of the free movement provisions, which would require the recognition of an implicit MFN-clause in those provisions[1764].

The Advocate-General also responds to opposing views. The governments which had submitted observations in the proceedings of the *D*-case maintained that Mr D's situation

[1763] § 97 of the Opinion.

[1764] A similar distinction is made by D. WEBER, "Most-Favoured-Nation Treatment under Tax Treaties Rejected in the European Community: Background and Analysis of the D Case", *Intertax* 2005, 429, 439, who argues that Mr D did not claim MFN-treatment but challenged discrimination between two categories of non-residents. Once again, this seems to be a confusion of cause and effect. As the fundamental freedoms are based on the prohibition of discrimination, it is natural that a form of discriminatory treatment is identified when invoking them. If one accepts that the fundamental freedoms lend themselves to horizontal comparisons, the inevitable consequence thereof is that they require MFN-treatment. Deciding that a Member State is prohibited from discriminating between two types of non-residents, automatically implies that that Member State must grant the most beneficial treatment to both types of non-residents (i.e. MFN-treatment). Therefore, it is clear that Mr D's appeal was not based on an MFN-clause in the TFEU but on the prohibition of discrimination as guaranteed by the fundamental freedoms. However, accepting his appeal would automatically mean that those freedoms also guarantee MFN-treatment.

could not be compared with that of a taxpayer resident in Belgium. Agreements concluded under the former Article 293 EC are the fruit of negotiations which include assessment of the framework and content of their respective tax systems. Therefore, in order to assess comparability in a specific factual situation, account cannot be taken of an isolated provision, or even of the entire convention, but the national taxation system as a whole must be considered. Thus, different treaty arrangements create different situations, which are not comparable. The Advocate-General responds to these arguments by stating that such a 'maximalist reasoning' would have *"precluded the rulings given in Gottardo and Saint-Gobain, or any test of equal treatment."* If, in addition to similarity between the factual circumstances and the applicable provisions, there must be similarity between the reasons, the grounds and the procedure followed for their approval and between the legal systems which incorporate the provisions being compared, it would never be possible to make a finding and there would never be comparable situations. The Advocate-General states that, in reality, the assessment is simpler and more limited, in so far as it is a matter of identifying whether two individuals in comparable factual circumstances are subject without justification to disparate rules and, in comparing those rules, the sole pertinent inquiry is whether their application leads to differing effects to the detriment of either of them[1765].

As to the dangers which this view might imply for the balance and reciprocity of tax treaties, the A.-G. observes that *"those difficulties must not become obstacles to the establishment of the single market."* First, when allocating tax competence in those tax treaties, the Member States must act with the utmost care, avoiding any provisions which might hinder the establishment of the single market. Second, *"the right to equal treatment stands alone and is independent from the principle of reciprocity and therefore, in the event of a conflict, it takes precedence over mutual commitments. If the reciprocity of the obligations in such an agreement runs counter to the fundamental ideas driving the construction of a unified Europe, the Member States in question have a duty to seek other formulae which, whilst achieving the objective sought, do not, in breach of Community law, prejudice the citizens of other Member States. The principle of proportionality so demands"*[1766].

As mentioned before, the Advocate-General seems to overlook an important aspect which distinguishes *D* from *Saint Gobain* and *Gottardo*: the different comparison to be made. Taking that difference into account, it becomes apparent why, in the Court's interpretation, the fundamental freedoms are not suited for an MFN-interpretation. The Treaty freedoms are based on the idea that discrimination is prohibited between the subject of comparison (be it a non-national or a non-resident) and a comparable internal situation. If the comparable internal situation is entitled to certain benefits under a treaty with a third State, those benefits should be extended to the subject of comparison, all other relevant elements being the same. The situation is different where the comparison is between different categories of non-residents. At first glance, *D* seems to suggest that the Court applies a stricter comparability-test in such horizontal cases. From a single market-perspective, however, such a differentiation is difficult to maintain. Suppose that Member State A introduces a tax benefit in its domestic legislation which is only applicable to residents of Member State B; not to residents of Member State C and not even to residents of Member State A. Such treatment would be equally detrimental to the internal market as a traditional type of discrimination, i.e. a tax benefit which is only available to State A-residents. It is therefore problematic that the ECJ refuses to accept such horizontal comparisons, as they are necessary to remove these types of impediments to the internal market. Of course, it is essential that in the *D*-case, the difference in treatment was

[1765] § 98-101 of the Opinion.
[1766] § 99 of the Opinion.

caused by an interplay of domestic law and a tax treaty, and not merely by domestic law. That might explain the ECJ's reluctance to consider the 'horizontal' discrimination discussed here (see infra).

b. ACT

As mentioned earlier, an important issue in the *ACT*-case concerned the difference in treatment caused by the divergent provisions in the tax treaties concluded by the U.K. As a result of these different provisions, companies resident in some Member States were not entitled to a tax credit in the U.K. when they received U.K.-sourced dividends, while companies resident in certain other Member States were granted a (partial) tax credit when receiving such dividends. The question also arose whether it was permissible for the U.K. to apply a limitation on benefits provision of a tax treaty, pursuant to which it did not grant a tax credit to a company resident in the other contracting Member State if that company was controlled by a company resident in a third State with which the U.K. had concluded a tax treaty which made no provision for a tax credit in respect of U.K.-sourced dividends.

Referring to § 52 of its *D*-judgment, the Court first stated that the scope of a bilateral tax treaty is limited to the persons referred to in it[1767]. Next, the Court observed that the terms under which the tax treaties provided for a tax credit for non-resident companies which received dividends from a resident company varied depending on the particular characteristics of the national tax regimes concerned, on when the tax treaties were negotiated and on the extent of the issues on which the Member States concerned managed to reach agreement. The situations in which the U.K. grants a tax credit to companies resident in the other contracting State which receive U.K.-sourced dividends are those in which the U.K. also retains the right to tax the companies on those dividends. The tax rate which the U.K. may charge in such cases varies according to the circumstances and, in particular, according to whether the tax treaty provides for a full or a partial tax credit. The Court concludes: *"there is thus a direct link between the entitlement to a tax credit and the rate of tax laid down under such a DTC."* Consequently, the grant of a tax credit to a non-resident company receiving dividends from a resident company, as provided for under a number of tax treaties concluded by the U.K., cannot be regarded as a benefit separable from the remainder of those treaties, but is an integral part thereof and contributes to their overall balance.

According to the Court, the same applies to the LOB-provisions at issue. Even where such provisions extend to the situation of a company which is not resident in one of the contracting Member States, they apply only to persons resident in one of those Member States and, by contributing to the overall balance of the tax treaties in question, are an integral part of them.

The ECJ then repeats is *D*-reasoning: the fact that the reciprocal rights and obligations of the tax treaty apply only to persons resident in one of the two contracting Member States is an inherent consequence of bilateral tax treaties. It follows, as regards the taxation of dividends paid by a U.K. resident company, that a company resident in a Member State which has concluded a tax treaty with the U.K. which does not provide for such a tax credit is not comparable to a company resident in a Member State which has concluded a tax treaty which does provide for one[1768]. So once again, two categories of non-residents are rendered

[1767] C-374/04, *ACT*, § 84.
[1768] C-374/04, *ACT*, § 85-91. It has been suggested that the Court's judgment in *ACT* is somewhat different from its *D*-reasoning because it also takes account of 'ability to pay' arguments in the comparability-test. In particular, the comparability between the two categories of non-residents was denied because they were not in the same

incomparable by the provisions of the applicable tax treaty, because the reciprocal rights and obligations applicable to one category of non-residents are an integral part of the tax treaty and contribute to its overall balance[1769].

> It should be noted that the High Court of Justice actually referred two separate tax treaty issues to the ECJ, but the ECJ joins them together. The first issue (question 1(b) in the order for referral) was whether it was compatible with the freedoms that, under the different tax treaties, companies resident in certain Member States (e.g. the Netherlands) were entitled to a tax credit in the U.K. when receiving U.K.-sourced dividends, while that was not the case for companies resident in certain other Member States (e.g. Germany). The second issue (question 1(c)) was the LOB-issue.
>
> In substance, the first issue is identical to the issue decided in the *D* case, so the ECJ was correct in transposing its *D* reasoning to this aspect of the *ACT* case: the grant of the credit is an integral part of the Dutch/U.K. treaty and contributes to its overall balance, which means that it cannot be extended to companies resident in Germany. From the perspective of the U.K. rules at issue, German residents are incomparable to Dutch residents because of the different tax treaties that apply to them[1770].
>
> The ECJ then states that *"the same applies"* to the LOB-issue. That issue concerned the distinction between Dutch companies that are controlled by German shareholders and Dutch companies that are controlled by Dutch or Italian shareholders. Because of the LOB-clause in the Dutch/U.K. treaty (and because of the absence of a credit in the German/U.K. treaty), only the latter category of Dutch companies was entitled to a credit. The Court holds that, even though the LOB clauses refer to the situation of German residents, they only apply to persons resident in the Netherlands (a contracting party to the Dutch/U.K. treaty) and, by contributing to the overall balance of the tax treaty, they are an integral part thereof[1771]. Consequently, the ECJ held that this aspect of the tax treaties was not discriminatory either.
>
> In my opinion, however, the *D* reasoning, which concerns the MFN-issue, is irrelevant for the LOB-issue. The LOB-question is not whether a Dutch company should be entitled to benefits granted by the U.K. under a tax treaty with a third State. The

---

situation as regards their ability to pay: under one tax treaty, the non-resident parent was subject to U.K. tax on the U.K. source dividends and it was entitled to a tax credit, whereas under the other tax treaty the non-resident parent was not subject to U.K. tax on the U.K. source dividends and it was not entitled to a tax credit. In other words, under the first treaty, the U.K. retained the right to tax the dividends received by the non-resident parent, whereas it had not retained that right under the second treaty. See S. VAN THIEL, "Why the European Court of Justice should interpret directly applicable Community law as a right to most-favoured nation treatment and a prohibition of double taxation", in D. WEBER (ed.), *The influence of European law on direct taxation*, Amsterdam, Kluwer Law International, 2007, 107, 110 and 134. This is remarkably similar to arguing that the tax treaty provisions on the allocation of taxing powers render the situations incomparable. However, it is difficult to reconcile that position with the Court's judgment in *Gilly*, where it was held that rules on the allocation of taxing powers do not come within the scope of EU law, which renders them immune to scrutiny under the ECJ's discrimination-test (and, consequently, under the comparability-test) (cf. infra).

[1769] Advocate-General Geelhoed had reached the same conclusion in his Opinion in *ACT* (Opinion of 23 February 2006, *ECR* 2006, I-11673, § 94-96). He first stressed that each tax treaty *"contains a specific allocation of tax jurisdiction and priority of taxation between the Contracting States."* This allocation represents an overall balance negotiated as a whole and on a reciprocal footing, on the basis of the particular features of the two national tax systems and economies at issue. The differences in equilibrium arrived at in such bilateral negotiations reflect the diversity of national tax systems and economic circumstances. As a result, non-residents subject to different balances of tax jurisdiction and priority rules arrived at in different tax treaties, are incomparable.

[1770] C-374/04, *ACT*, § 83-88.

[1771] C-374/04, *ACT*, § 89-91.

question is whether the U.K. can distinguish between companies resident in the same Member State (the Netherlands) under one tax treaty (the Dutch/U.K. treaty) depending on the place of residence of their shareholders. That is not an MFN issue[1772]. So the comparison was not between a Dutch company, which is covered by the Dutch/U.K. treaty, and a company of a third State, which is covered by the treaty between the U.K. and that State, but between two Dutch companies covered by the same treaty but entitled to different benefits under that same treaty[1773]. It would therefore have been preferable for the Court to first confirm that the subject and object of comparison were comparable, but then determine whether it was nevertheless justified to distinguish between them. For instance, it could be said that the LOB clause in the Dutch/U.K. treaty was justified by the need to prevent abuse consisting of the interposition of Dutch companies by German shareholders of U.K. companies (assuming that it is proportionate to that aim)[1774].

Accordingly, it is unclear why the ECJ does not apply the reasoning it applied in, for instance *Gottardo*, to the LOB-issue in *ACT*. As discussed above, Mrs Gottardo did not claim MFN treatment in Italy, she only claimed the rights to which Italian nationals were entitled (i.e. national treatment) under the Italian/Swiss treaty. The Court allowed her claim, as a result of which the scope *ratione personae* of the Italian/Swiss treaty was extended. There is no reason to decide the LOB-issue in *ACT* differently: the Dutch company with German shareholders did not claim MFN treatment in the U.K., but only to be granted the same treatment as Dutch companies with Dutch or Italian shareholders, i.e. an extension of the scope *ratione personae* of the Dutch/U.K. treaty[1775].

c. Orange European Smallcap

As mentioned in 2.E.I.A.b.6.b.6, part of the *Orange European Smallcap*-judgment concerned the influence of tax treaties on the comparison. After comparing the treatment of the German- and Portuguese-sourced dividends to the treatment of Dutch-sourced dividends, the comparison was thus made between the treatment of the German- and Portuguese-sourced dividends and the treatment of dividends sourced in certain other Member States (e.g. Italy,), the latter granting entitlement to the tax concession in the Netherlands[1776].

The Dutch government referred to the purpose of the concession, i.e. to make the tax burden on the proceeds from investments made through fiscal investment enterprises (FIEs) the same as that on direct investments made by individuals. For that reason, the concession was restricted to the circumstances in which there was a right to credit the foreign tax deducted against Dutch tax pursuant to a tax treaty. In addition, the Dutch government argued that it

---

[1772] See also P. PLANSKY and H. SCHNEEWEISS, "Limitation on benefits: from the US Model 2006 to the ACT Group Litigation", *Intertax* 2007, 492. Additionally, since the LOB-issue does not concern the allocation of taxing powers but the exercise thereof, the *Gilly*-exception to the applicability of the fundamental freedoms does not apply.

[1773] The Advocate-General made the correct comparison: *"The question here is whether it is permissible to distinguish between non-residents which are resident in the same Member State and thus covered by the same DTC, depending on whether the non-resident is controlled by a resident of a Member State (or third country) whose DTC with the UK does not make provision for partial tax credits"* (Advocate-General Geelhoed's Opinion in C-374/04, *ACT*, 23 February 2006, § 100). However, he subsequently applied the *D* reasoning and thus arrived at the same conclusion as the Court.

[1774] L. DE BROE, *International tax planning and prevention of abuse*, IBFD, Amsterdam, 2008, 1053-1054, who also discusses whether the distinction is justified on the basis of cohesion.

[1775] See also L. DE BROE, *International tax planning and prevention of abuse*, IBFD, Amsterdam, 2008, 1055.

[1776] For the sake of clarity, I will only refer to German-sourced dividends from here on, it being understood that the same reasoning applies to Portuguese dividends.

followed from the *D*-case that the situation in which an investor receives a German-sourced dividend differs from that in which the dividend is sourced in a Member State with which the Netherlands has concluded a tax treaty granting the right to credit the foreign tax deducted against Dutch taxation (e.g. Italy). According to the Dutch government, *"the concession to be granted is indissociably linked to the right of the shareholder of a fiscal investment enterprise, pursuant to such a convention, to set off the foreign tax deducted at source."* Consequently, that concession should, like the right of set-off, be regarded as an integral part of the tax treaty and not as a benefit separable from it[1777].

The ECJ first refers to its conclusion with respect to the vertical comparison (i.e. the comparison with Dutch-sourced dividends), that the Netherlands, as the residence State, was not required grant relief where the double taxation was entirely due to the source State (see supra, 2.E.I.A.b.6.b.6). However, the Court then adds that, where a Member State has decided to grant relief, it must do so in accordance with the free movement provisions. It is up to the Member States to organise their systems for taxing distributed profits and to define the tax base and the tax rate applicable to the shareholder receiving them. In the absence of harmonising measures, the Member States thus retain the power to allocate taxing powers between them, unilaterally or in a tax treaty. The Court concludes: *"given the resulting disparities between the tax laws of the various Member States, a Member State may find it necessary, by treaty or unilaterally, to treat dividends from the various Member States differently so as to take account of those disparities"*[1778].

The ECJ then refers to its position in *D* and in *ACT* that, where a benefit granted by a bilateral tax treaty cannot be classified as a benefit that is separable from that treaty but contributes to its overall balance, a resident of a third Member State is not comparable to residents covered by the treaty in question. In the case at hand, the application of the Dutch concession-regime resulted in different treatment of dividends from different Member States: the concession was only granted in situations where the tax treaty provided that individuals could credit the tax withheld at source against their income tax due in the Netherlands. In this regard, the ECJ indicates that the payment of the concession did not result from the automatic application of a tax treaty, but from the unilateral decision of the Netherlands to extend the benefit of such treaties to FIEs. According to the Court, that unilateral decision in itself could not infringe the fundamental freedoms because its purpose was to take account of the disparities resulting from the Member States' sovereignty to allocate taxing powers (see supra).

Nevertheless, the Court then considers whether the difference in treatment resulting from that unilateral decision gave rise to an infringement of the fundamental freedoms[1779]. In that respect, the comparability-test is decided against the backdrop of the purpose of the measure under scrutiny. As indicated earlier, the concession regime sought to equate the tax treatment of dividends received by a shareholder investing directly and those received through the intermediary of an FIE, so as to prevent the latter type of investments from being less appealing than direct investments. As regards comparability, the ECJ observes that *"under such legislation, where a fiscal investment enterprise receives dividends from Member States with which the […] Netherlands has concluded a convention providing for shareholders who are natural persons to be entitled to credit the tax which those Member States have deducted from the dividends to the income tax for which those shareholders are liable in the Netherlands, the situation of that enterprise is different from that in which it finds itself when*

[1777] C-194/06, *Orange European Smallcap*, § 46.
[1778] C-194/06, *Orange European Smallcap*, § 47-49.
[1779] C-194/06, *Orange European Smallcap*, § 51-55.

receiving dividends from Member States with which the […] Netherlands has not concluded such a convention, as there is no such entitlement in respect of those dividends".

In other words, the existence of a tax treaty which grants individuals the possibility to credit the tax withheld at source renders the situations incomparable. The underlying reason is that the risk that an investment through the intermediary of an FIE is less advantageous to a shareholder than direct investment only exists where such a tax treaty applies. By contrast, as regards investments in Member States where no such tax treaty applies, the decision to invest through the intermediary of an FIE does not involve the risk of being less advantageous than a direct investment. As a result, the situations were not comparable, which meant that there was no discrimination of German-sourced dividends as compared to dividends from Member States with which the Netherlands has concluded a tax treaty granting individuals the possibility to credit the tax withheld abroad[1780].

> It should be mentioned that the Court's observation that *"the payment of the concession does not result from the automatic application of a bilateral tax convention, but from the unilateral decision of the Netherlands to extend the benefit of such conventions to fiscal investment enterprises"* was inspired by the Advocate-General Bot's opinion in *Orange European Smallcap*. However, the Advocate-General drew a completely different conclusion from this observation. Referring to *Cadbury-Schweppes* (cf. infra), he first observed that the prohibition of discrimination under the fundamental freedoms is not only aimed at differences in treatment between a resident taxpayer who invests in his State of residence and a resident taxpayer who invests in another Member State, but also to national measures which differentiate between Member States and which treat investments in one Member State less favourably than those in another Member State. As to the facts at issue in *Orange European Smallcap*, the A.-G. noted that neither an FIE which invests in Germany, nor an FIE which invests in another Member State such as Italy was covered by a tax treaty. The fact that the FIE investing in Italy benefits from a concession for the deduction at source on Italian-sourced dividends *"does not therefore result from the automatic application of the bilateral convention concluded between the [….] Netherlands and [Italy] but from a unilateral decision of the Netherlands Government to extend the benefit of that convention to fiscal investment enterprises."*
>
> As a result, it could not be said that the right of such FIEs to set off the tax deducted at source in a Member State forms an integral part of the tax treaty in question and contributes to its overall balance. Extending entitlement to the concession to German-sourced dividends would not therefore jeopardise the balance and reciprocity of the commitments contained in the tax treaties concluded by the Netherlands. In conclusion, the A.-G. held that the prohibition of discrimination meant that, as soon as the Dutch legislature decided to grant FIEs a concession for deductions at source applied to dividends originating in certain Member States when it was not required to do so under the tax treaties concluded with those States, it could not exclude from that advantage dividends originating in other Member States such as Germany[1781].

It is not immediately clear how to interpret the Court's position on horizontal comparability in *Orange European Smallcap*. In particular, it is unclear how the Court's position relates to its earlier position in *D*. Unlike in *D*, the Court notes in *Orange European Smallcap* that the disadvantage is not due to the tax treaty, but due to a unilateral decision of the Netherlands.

[1780] C-194/06, *Orange European Smallcap*, § 55-65.
[1781] Advocate-General Bot's opinion in C-194/06, *Orange European Smallcap*, 3 July 2007, *ECR* 2008, I-03747, § 101 and 106-108.

Nevertheless, the Court does not find this decision to be discriminatory, as the situations at issue are incomparable. In contrast, the Advocate-General considered the situations to be comparable and therefore concluded that the measure amounted to horizontal discrimination.

What seems to be particularly important in the Court's line of reasoning is the objective of the domestic measure. That measure sought to treat direct investments and investments through the intermediary of an FIE identically. As noted in 2.E.I.A.b.6.b.6, the relevant characteristic from the perspective of that objective is the difference between the tax treatment of a direct investment and the tax treatment of an investment through an FIE (and, consequently, the risk that the latter type of investment is treated less favourably than the former type). Thus, in situations where individual taxpayers investing directly were entitled to a credit for tax withheld abroad, the domestic measure granted a concession to FIEs in order to guarantee neutrality between both types of investment. By contrast, no such concession was necessary to achieve neutrality where individuals were not entitled to a tax credit. Since the relevant characteristic differs between the subject of comparison (FIEs receiving German dividends) and the object of comparison (FIEs receiving Italian dividends), the Court decides that the situations were not comparable.

In other words, the issue in *Orange European Smallcap* has little to do with the *D*-issue. The *D*-reasoning explains why individuals investing in Germany are incomparable to individuals investing in Italy: the tax credit which is granted to the latter category but not to the former is an integral part of the Dutch/Italian tax treaty and contributes to its overall balance. As a result, distinguishing between those categories of individuals as regards entitlement to the credit does not give rise to discrimination. However, that was not at issue in *Orange European Smallcap*. Instead, the question was whether it was discriminatory for the Netherlands to extend the benefit of a tax treaty to FIEs investing in Italy while refusing it to FIEs investing in Germany. As the Advocate-General observed, that difference in treatment was not due to differing tax treaty provisions, but due to a unilateral extension of treaty benefits to certain FIEs by the Netherlands. As a result, it could not be said that the right to the tax credit formed an integral part of the Dutch/Italian tax treaty and contributed to its overall balance. Extending entitlement to the concession to German dividends would not therefore jeopardise the balance and reciprocity of that treaty[1782]. As a result, the Court was free to disregard the *D*-exception and to take account only of the domestic provisions at issue. Ultimately, the Court held that the situations were incomparable with the result that the distinction did not give rise to discrimination. Given the purpose of the Dutch measure at issue, that conclusion was entirely correct. As noted in 2.E.I.A.b.6.b.6, however, it would have been preferable if the Court had taken the same position with respect to the vertical issue, i.e. the comparison between German dividends and domestic dividends.

In any event, the Court's line of reasoning suggests that horizontal comparisons are possible in situations where the disadvantage is not caused by a tax treaty but by domestic law. Ultimately, no discrimination was found to be present in *Orange European Smallcap* because of the incomparability in the specific context of the Dutch regime, but the ECJ does not seem reluctant to apply its traditional analysis to horizontal situations. In *Cadbury Schweppes* and *Columbus Container*, the Court was given the opportunity to confirm this position (see 2.E.I.A.b.9.e).

[1782] Advocate-General Bot's opinion in C-194/06, *Orange European Smallcap*, 3 July 2007, § 107.

d. Interim conclusion: reciprocity and the balance of tax treaties in the comparability-test

1. The importance of the concepts of reciprocity and the balance of tax treaties in the ECJ's case law

In order to fully comprehend what the Court means when it refers to 'reciprocity' and 'the balance of tax treaties', it is necessary to go back to the very beginning of its case law in these matters. It should come as no surprise that the roots of this reasoning can be traced back to *Avoir fiscal*.

In defense of its tax system in that case, the French government argued that the disadvantage was actually due to the applicable tax treaty, and therefore outside the scope of the Treaty freedoms. The Court dismissed this argument and held that *"the French government is wrong to contend that the difference of treatment in question is due to the double-taxation agreements. […] The rights conferred by Article 52 of the Treaty are unconditional and a Member State cannot make respect for them subject to the contents of an agreement concluded with another Member State. In particular, that Article does not permit those rights to be made subject to a condition of reciprocity imposed for the purpose of obtaining corresponding advantages in other Member States"*[1783].

So in *Avoir fiscal*, the Court seems to dismiss the relevance of reciprocal rights and obligations, but it should be stressed that the assessment being made here concerned the disadvantage-test, and not the comparability-test. The influence of tax treaties, and their inherent reciprocal nature, on the disadvantage-test will be discussed elsewhere (cf. 2.E.I.B.e). Nevertheless, it is striking that the Court took account of the concept of reciprocity at a very early stage in the development of its direct tax case law. However, it took some time before the implications of this concept for the comparability-test came into focus.

In *Wielockx*, the Court also referred to the concept of reciprocity. The Dutch government invoked the principle of fiscal cohesion in order to justify its legislation. In order to establish the necessary correlation between the deductibility and the taxability of the income, the Dutch government argued that, if a non-resident could set up a pension reserve in the Netherlands and thus secure a right to a pension, that pension would not be taxed in the Netherlands since such income was only taxable in the State of residence by virtue of the Belgian/Dutch tax treaty. The Court responded to this argument by stating that the effect of tax treaties which follow the OECD MC is that a State taxes all pensions received by its residents, whatever the State in which the contributions were paid, but, conversely, waives the right to tax pensions received by non-residents even if they derive from contributions paid in its territory which it treated as deductible. From this, the Court concludes: *"fiscal cohesion has not therefore been established in relation to one and the same person by a strict correlation between the deductibility of contributions and the taxation of pensions* ***but is shifted to another level, that of the reciprocity of the rules applicable in the Contracting States****. Since fiscal cohesion is secured by a bilateral convention concluded with another Member State, that principle may not be invoked to justify the refusal of a deduction such as that in issue."*[1784]. Once again, the Court takes account of the inherent reciprocal nature of tax treaties, without, however, assessing its influence on the comparability-test. Reciprocity is only used here in order to dismiss the fiscal cohesion-justification of the Dutch government (i.e. by waiving its taxing rights over the pensions under the tax treaty, the Netherlands forfeited the coherence of its tax

[1783] C-270/83, *Avoir fiscal*, § 26.
[1784] C-80/94, *Wielockx*, § 23-25 (emphasis added).

system as the possible correlation between deductibility and taxation of the income; see 2.F.III.B).

The *Saint Gobain*-judgment, which has been touched upon earlier, was the next step in the Court's evolution. In that case, the French company's PE in France was considered to be comparable to a German resident company, despite the existence of a tax treaty. The Court decided that, in the case of a tax treaty concluded between a Member State and a third country, "*the national treatment principle requires the Member State which is party to the treaty to grant to permanent establishments of non-resident companies the advantages provided for by that treaty on the same conditions as those which apply to resident companies.*" As to the reciprocity and balance of the tax treaty, the Court added that the obligations which the Treaty freedoms imposed on Germany did not affect in any way those resulting from its tax treaties with the U.S. and Switzerland: *"the balance and the reciprocity of the treaties concluded by […] Germany with those two countries would not be called into question by a unilateral extension, on the part of […] Germany, of the category of recipients in Germany of the tax advantage provided for by those treaties […] since such an extension would not in any way affect the rights of the non-member countries which are parties to the treaties and would not impose any new obligation on them"*[1785].

Once again, it is remarkable that the Court does not take account of the reciprocal nature of the treaty in the actual comparability-test (in contrast to its later judgments in *D* and *ACT*), but rather decides (implicitly) that the situations are comparable **despite** the existence of reciprocal rights and obligations under the treaty. In fact, the concept of reciprocity in *Saint Gobain* is restricted to the justification-analysis – as it was in *Wielockx*. The reason why the concept came up for discussion in *Saint Gobain* was because the Swedish government had argued that tax treaties *"are based on the principle of reciprocity and that the balance inherent in such treaties would be disturbed if the benefit of their provisions was extended to companies established in Member States which were not parties to them"*[1786].

This is even more clear in *Gottardo*, which was to a great extent inspired by *Saint Gobain*. In *Gottardo*, the Court stated that "*disturbing the balance and reciprocity of a bilateral international convention concluded between a Member State and a non-member country may, it is true, constitute an objective justification for the refusal by a Member State party to that convention to extend to nationals of other Member States the advantages which its own nationals derive from that convention"*[1787]. Thus, the Court seems to accept in *Gottardo* (and perhaps implicitly in *Saint Gobain*) that the balance and reciprocity of a bilateral agreement may justify the refusal of the Member State party to that agreement to extend the advantages

[1785] C-307/97, *Saint Gobain*, § 58-59. It should be stressed that *Saint Gobain* does not imply that residents of Member States are able to gain automatic access to tax treaties concluded by other Member States. The Court's decision in *Saint Gobain* that Germany was required to grant 'national treatment' (i.e. extend the dividend tax advantages reserved for its resident companies) to German PEs of companies resident in other Member States, did not imply that the French company gained access to the German/U.S. treaty. If the opposite were true, then the U.S. would be obliged to grant the tax treaty advantages to a person who was not a resident of either the U.S. or Germany. The Court only required Germany, pursuant to that State's obligations under the freedom of establishment, to grant 'national treatment' to the French company. According to the Court, this unilateral extension of the tax advantage would not upset the tax treaty balance, because the obligation of national treatment was an obligation of Germany and not of the U.S. See also T. O'SHEA, "Freedom of establishment tax jurisprudence: Avoir Fiscal re-visited", *EC Tax Review* 2008, 266.
[1786] C-307/97, *Saint Gobain*, § 55.
[1787] C-55/00, *Gottardo*, 15 January 2002, § 36, referring to *Saint Gobain*.

arising therefrom to non-residents[1788]. Nevertheless, the Court had still yet to address the influence of these concepts on the comparability-test, which it eventually did in its *D*-judgment.

2. Distinguishing D and ACT from the earlier case law

As mentioned earlier, the main difference between the *D*-case and the case law before that was the comparison to be made: in the *D*-case, the comparison was between two different categories of non-residents, whereas the other cases had all been concerned with the traditional comparison between a resident and a non-resident[1789]. Assuming that this distinction is the reason why the outcome of the cases is different[1790], the question arises why the Court considers this distinction to be so important. If the Court considers that the fundamental freedoms are based on a prohibition of discrimination as compared to nationals or residents (as suggested earlier), it would have been much clearer to dismiss the possibility to make horizontal comparisons out of hand, without taking a detour through the principles of reciprocity and the balance of a tax treaty.

Obviously, it is also possible that the Court is reluctant to compare different categories of non-resident taxpayers, not because of conceptual objections, but simply because it feels MFN-treatment may upset the application of tax treaties. More specifically, there seems to be the idea that reading an MFN-requirement in the fundamental freedoms could oblige Member States to apply the most beneficial withholding rates agreed in a tax treaty with one Member State to all other Member States. However, that idea is probably unwarranted, given the *Gilly*-case law. In *Gilly*, the Court held that tax treaty clauses allocating tax jurisdiction between Member States fall outside the scope of the Treaty freedoms and therefore do not constitute discrimination. As tax treaty provisions on reduced withholding rates concern the allocation of taxing powers, they are covered by the *Gilly*-case law[1791]. By contrast, the tax treaty rule

---

[1788] Of course, it could be argued that the concept of reciprocity is fundamentally different in social security agreements and in tax treaties. In social security agreements, the compromise (if present at all) is not a bargain concerning different rules on the allocation of sovereign powers, but concerns only one set of rules (regarding expenditure with social security benefits). The same is true for the bilateral aviation agreements at issue in *Open Skies*: all the rights and obligations in those agreements implied reciprocity and favourable treatment, but no sharing of potentially overlapping sovereign powers: K. VOGEL, D. GUTMAN and A. DOURADO, "Tax treaties between member States and third States: 'reciprocity' in bilateral tax treaties and non-discrimination in EC law", *EC Tax Review* 2006, 84-85.

[1789] It could be argued that there was an additional difference, in that the disadvantage in *Saint Gobain* was caused by national law, whereas it was the result of the tax treaty in *D*: see M. LANG and S. DOMMES, "Tax treaty law and EC law – Reciprocity and the balance of a tax treaty", in M. LANG, J. SCHUCH and C. STARINGER (eds.), *Tax treaty law and EC law*, Kluwer Law International, Alphen aan den Rijn, 2007, 74. The same can be seen in *ACT* where the disadvantage was due to divergent tax treaty provisions. However, that difference seems to be a consequence of the different comparison being made. As the comparison is between different types of non-residents, it seems logical that the differential treatment is caused by divergent treaty provisions: it is unlikely that the domestic law of a Member State would expressly differentiate between different types of non-residents. Moreover, the different treatment in *Orange European Smallcap* was the result of the unilateral decision of the Netherlands to extend the benefit in certain cases (cf. § 107 of the Advocate-General's opinion and § 54 of the judgment).

[1790] In any event, it is difficult to reconcile that position with the clear wording of Art. 18 TFEU, the general expression of the prohibition of discrimination which underlies the fundamental freedoms. Art. 18 TFEU prohibits **any** discrimination on grounds of nationality. Accordingly, not only discrimination between nationals and non-nationals or indirect discrimination between residents and non-residents is prohibited, but also discrimination between different categories of non-nationals and indirect discrimination between different categories of non-residents (cf. supra).

[1791] As the tax treaty obligation of the source State to reduce its withholding rates generally corresponds to an obligation on the State of residence to grant an ordinary credit, these two obligations concern the allocation of under scrutiny in *D* (an allowance given to a non-resident in respect of wealth tax) was not a rule on the allocation of taxing powers[1792]. If it was, the ECJ could have restricted itself to a reference to *Gilly* in order to establish that the matter fell outside the scope of the Treaty freedoms. A comparability-analysis would therefore have been unnecessary. But since the tax treaty provision at issue in *D* was not a rule on the allocation of taxing powers, the Court went on to apply its comparability-analysis. In that respect, it held that German residents were incomparable to Belgian residents, since the latter came within the scope of application of Art. 25(3) of the Belgian/Dutch treaty, i.e. *"a reciprocal right which is an integral part of the treaty and contributed to its overall balance"* (see supra).

Broadly speaking, two positions on these issues can be distinguished in legal literature. One group of authors argues that the fundamental freedoms do not allow for an MFN-requirement, while another group takes the position that the ECJ does not go far enough and should interpret the fundamental freedoms as requiring MFN-treatment.

The first of these positions, i.e. that the fundamental freedoms do not allow for an MFN-requirement, often seems to overlook the relevance of *Gilly* in this respect[1793]. Not every provision of a tax treaty is intended to allocate taxing powers between the contracting States. If the provisions at issue concern the allocation of taxing powers, there can be no discrimination contrary to the Treaty freedoms, since such provisions do not fall within the scope of the freedoms. But if the provisions in question do not allocate taxing powers, that argument cannot be applied. As a result, there is no reason why benefits resulting from such provisions cannot be subject to the discrimination-test under the fundamental freedoms[1794]. However, the Court has pointed out that certain tax treaty provisions are *"an integral part of the tax treaty and contribute to its overall balance"*, even though they clearly do not allocate taxing powers. Where a non-resident comes within the scope of such a provision, he is incomparable to another non-resident who does not come within that scope. That was, for instance, the case for the tax treaty provision at issue in *D*. On the other hand, it is possible (at least in theory, see infra) that a tax treaty provision grants *"benefits separable from the remainder of the tax treaty"*. In such a case, there is nothing to prevent the Court from considering non-residents governed by such treaty provisions to be comparable to other non-residents.

---

tax jurisdiction between the two States rather than the tax liability of the taxpayer. For a detailed analysis, see R. VAN DER LINDE, "Some thoughts on most-favoured-nation treatment within the European Community legal order in pursuance of the D case", *EC Tax Review* 2004, 14; S. VAN THIEL, "A slip of the European Court in the D case (C-376/03): denial of the most-favoured-nation treatment because of absence of similarity?", *Intertax* 2005, 456.

[1792] As expressly noted by the Court in C-376/03, *D*, § 53: *"The main proceedings do not, however, relate to the consequences of allocating powers of taxation in relation to nationals or residents of Member States that are party to a convention"*.

[1793] See D. WEBER, "Most-Favoured-Nation Treatment under Tax Treaties Rejected in the European Community: Background and Analysis of the D Case", *Intertax* 2005, 443.

[1794] The Commission has taken a similar position and, accordingly, focusses on whether the tax treaty provision is allocative in nature. See R. LYAL, "The position taken by the Commission in Case C-376/03, D v Belastingdienst", *European Taxation* 2005, 340 *et seq*. However, the Commission was of the opinion that the rules at issue in *D* were allocative in nature (R. LYAL, *o.c.*, 341-342). It should be mentioned that the Commission has also rejected the existence of an MFN-obligation in respect of withholding taxes: *"current community law does not oblige a Member State to grant automatically the withholding tax rate of its most favourable bilateral agreement to taxpayers of another Member State which is not covered by that agreement"* (written question No. 647/92 by Christa RANDZIO-PLATH and Karla PEIJS to the Commission. Different treatment for the distribution of dividends by companies based in a Member State and those based in a third country. Answer given by Mrs SCRIVENER on behalf of the Commission, *OJ* 1993, C 040/18, 14).

Furthermore, the criticism on the other side of the spectrum also seems to overlook the relationship between *Gilly* and *D*. Authors defending the position that the Treaty Freedoms should be interpreted as a right to MFN-treatment often criticise the *D*-judgment for three reasons. First, they argue that the Court's reasoning is far too formalistic, as it allows a clear discrimination to persist merely because it is laid down in a tax treaty. If the same measure were a part of domestic law, it would not withstand the Court's scrutiny[1795]. Secondly, these authors also argue that the allowance granted in the Belgian/Dutch tax treaty was a disguised tax advantage as there was no wealth tax in Belgium. Consequently, reciprocity (which should always underlie rules on the allocation of taxing powers) was not achieved[1796]. Finally, these authors point out that the Court's position is based on circular reasoning. The Court allows different treatment because the situations are not comparable. The reason why they are not comparable is because they are treated differently for wealth tax purposes on the basis of a tax treaty. As a result, the Court allows different treatment because there is different treatment[1797].

As to the first argument, the comparison to *Gilly* clearly shows that the non-comparability is not merely explained by the fact that the measure is laid down in a tax treaty, but because it is an integral part of that treaty and contributes to its overall balance. This is not a purely formal criterion: only those tax treaty provisions which are inseparable from the remainder of the treaty render the situations incomparable. Unfortunately, the Court has not indicated when or why a tax treaty provision is separable from the remainder of the treaty.

The second argument starts from an overly narrow interpretation of the concept of reciprocity. As noted above, reciprocity does not merely mean that State A grants a benefit to State B residents while State B grants the same benefit to State A residents. Rather, that concept refers to the inherent balance in a tax treaty, which can be explained by the bilateral negotiations giving rise to the treaty. Because the two States involved have to make certain concessions in order to achieve their goals during the treaty negotiation process, every benefit granted under a tax treaty is inherently 'reciprocal' in nature, in that it forms part of the concessions made by one contracting State in order to obtain concessions from the other contracting State. So the mere fact that Belgium did not levy wealth tax does not mean that the benefit granted in Art. 25(3) of the Belgian/Dutch treaty was not 'reciprocal'. That benefit was reciprocal because it contributed to the negotiated balance of the treaty.

The third argument is that the *D*-judgment is based on circular reasoning in that the Court considers two non-residents to be incomparable as regards the entitlement to a tax treaty benefit because one of them is entitled to that benefit while the other is not. It is correct that

[1795] E.g. S. VAN THIEL, "Why the European Court of Justice should interpret directly applicable Community law as a right to most-favoured nation treatment and a prohibition of double taxation", in D. WEBER (ed.), *The influence of European law on direct taxation,* Amsterdam, Kluwer Law International, 2007, 103; S. VAN THIEL, "The future of the principle of non-discrimination in the EU: towards a right to most favored nation treatment and a prohibition of double burdens?", in R. AVI-YONAH, J. HINES and M. LANG (eds.), *Comparative fiscal federalism,* Alphen aan den Rijn, Kluwer Law International, 2007, 364.

[1796] D. WEBER, "Most-Favoured-Nation Treatment under Tax Treaties Rejected in the European Community: Background and Analysis of the D Case", *Intertax* 2005, 434, 441-442. *Contra*, K. VOGEL, D. GUTMAN and A. DOURADO, "Tax treaties between member States and third States: 'reciprocity' in bilateral tax treaties and non-discrimination in EC law", *EC Tax Review* 2006, 85-86.

[1797] E.g. S. VAN THIEL, "A slip of the European Court in the D case (C-376/03): denial of the most-favoured-nation treatment because of absence of similarity?", *Intertax* 2005, 455; G. KOFLER and C. SCHINDLER, "Dancing with Mr D: the ECJ's denial of most-favoured-nation treatment in the D case", *European Taxation* 2005, 537; M. LANG and S. DOMMES, "Tax treaty law and EC law – Reciprocity and the balance of a tax treaty", in M. LANG, J. SCHUCH and C. STARINGER (eds.), "Tax treaty law and EC law", Kluwer Law International, Alphen aan den Rijn, 2007, 75.

incomparability can never be explained by simply referring to the difference in treatment which is at stake. When assessing the comparability of the situations (the first step in the Court's analysis), the alleged difference in treatment (which is to be examined in the second step) should be ignored and left out of the equation. For instance, where residents are taxed at a lower rate than non-residents, it cannot be argued that the situations are incomparable because of the lower rate applicable to residents. But that was not really the issue in *D*. In that case, the German resident claimed entitlement to a tax allowance provided for in Dutch domestic law. He made the comparison with a Belgian resident, who was entitled to that benefit. But the reason why the Belgian resident was entitled to that benefit, was the provision in the Belgian/Dutch tax treaty. And because that provision was an inherent part of the treaty, it rendered the situations incomparable (see supra). So it is essential that Mr D did not claim entitlement to the Belgian/Dutch treaty, but to the benefit granted under Dutch domestic law. In other words, the disadvantage at issue was not that German residents did not come within the scope of the Belgian/Dutch tax treaty. The disadvantage challenged by Mr D was that he was not entitled to a benefit provided for in Dutch domestic law. Consequently, it was not necessary for the Court to leave the relevant characteristic of being entitled to the Belgian/Dutch treaty out of the equation when making the comparison (but see infra, 2.E.I.A.b.9.f).

Put briefly, where the Court compares two non-residents, it seems to distinguish three types of tax treaty provisions. First, treaty provisions that allocate taxing powers go beyond the scope of the fundamental freedoms. If a taxpayer incurs a disadvantage because of such a provision, he cannot rely on the fundamental freedoms (*Gilly*). Secondly, tax treaty provisions which are an inherent part of that treaty and contribute to its overall balance can be analysed under the discrimination-test, but non-residents to which such provisions apply are incomparable to other non-residents. Finally, tax treaty provisions which can be separated from the remainder of the treaty do not render the situations incomparable. A taxpayer suffering a disadvantage because of such a provision can succesfully invoke the fundamental freedoms. However, given the Court's understanding of reciprocity, it seems unlikely that a tax treaty provision can ever be regarded as a benefit separable from the remainder of the treaty. Since the concept of reciprocity expresses the balance achieved between the contracting parties' conflicting interests through the treaty negotiation process, it seems that every tax treaty provision contributes to that balance. It is unlikely that contracting States would include a provision in a tax treaty without negotiating its merits and without trying to balance benefits granted to the other State's residents against benefits secured for its own residents[1798]. In contrast, where the Court compares a resident and a non-resident, it seems to take a more liberal approach towards tax treaty provisions (e.g. *Saint-Gobain*).

That being said, it could also be argued that the sudden shift between both lines of case law (i.e. *Saint Gobain* and *D*) can be explained by a more general (and more perilous) evolution in the Court's case law. It seems that the Court has started to incorporate several arguments which it traditionally analysed under the justification-test into the comparability-test and the disadvantage-test. The shift in the Court's case law on reciprocity could thus be seen as an aspect of this general tendency. That would mean that the ideas underlying the *Saint Gobain*-line of cases are the same as those underlying the *D*-line of cases, the only difference being that these ideas are applied in different steps of the analysis. The most obvious reason for this

[1798] Since the analysis made here is based on an *a contrario* reasoning, it is not certain that the ECJ actually meant to distinguish a third category. That is to say, the Court in *D* only held that the benefit at issue in that case was **not** separable from the remainder of the tax treaty. The Court did not say that there are also benefits which **are** separable therefrom.

general tendency in the Court's case law is that justifications require additional tests, notably the proportionality-test. When deciding that a national measure is not discriminatory because the situations are not comparable, the analysis stops. By contrast, where the Court considers that a measure may be justified by a certain imperative reason of public interest, the measure still needs to be proportional to the objective it seeks to attain. Therefore, by shifting the analysis of certain arguments from the justification-test to the comparability-test, the Member States are granted more elbow room in defending their national tax systems. Another reason, which can be strikingly illustrated by the Court's case law on reciprocity, might be that a shift from justification to comparability (or disadvantage) allows the Court to overturn its settled case law in a certain field, without making it explicit. Indeed, one could infer from *Saint Gobain* that reciprocity could only be accepted as a justification ground if the rights of non-Member States were affected or if new obligations would be imposed on them. Assuming that the incomparability in the *D*-case was actually a disguised justification ground, it is clear that the interpretation of that justification ground has been significantly broadened as compared to *Saint Gobain*. From a conceptual point of view, however, such a shift should be avoided. As will become apparent in 2.F.III, there is a fundamental difference between arguments pertaining to comparability and those pertaining to justification. Apart from the detrimental effect which this evolution could have on the furthering of the internal market, it is important that the Court's case law is based on a strict analytical model, characterised by conceptual clarity and consistency.

Finally, whatever the reason for the Court's decision to reject an MFN-interpretation of the fundamental freedoms, it is clear that the realisation of an actual internal market, unfettered by discriminatory measures (whether they be vertical or horizontal), requires market participants to be granted MFN-treatment[1799]. Yet, it seems that the state of European tax law, as it stands, does not allow for such an interpretation of the fundamental freedoms[1800].

> As a side-note, it should be pointed out that 'reciprocity' as it has been discussed here in the context of the ECJ's comparability analysis may seem to differ somewhat from 'reciprocity' as it has been described in the context of Art. 24 OECD MC (see Part II, 2.B.VII) but, in reality, both are different consequences of the same general concept of reciprocity. This concept of reciprocity means that every benefit granted by a Contracting State contributes to an intricate balance shaped by the give-and-take nature of the negotiation process. As a result of this inherent balance, the non-observance by one contracting State of its obligations under the treaty has certain consequences for the obligations of the other contracting State. In Part II, 2.B.VII, I

[1799] It should be stressed that this study is not concerned with fiscal federalism. I will not debate the desired degree of harmonization in the EU. Starting from the premise that an internal market requires (vertical and horizontal) discrimination to be abolished, the objective is merely to verify whether the tools currently used are sufficient to achieve that goal.

[1800] For a related issue, see C-451/05, 11 October 2007, *ELISA*, concerning the French annual 3% tax on immovable property. That tax was not applicable to legal persons having their place of effective management in France. Additionally, the tax did not apply to legal persons having their management elsewhere if they were entitled to non-discriminatory treatment in France on the basis of a tax treaty or if their State of residence had a tax treaty with France providing for administrative assistance in tax matters. The ECJ held that this distinction constituted an unjustified discrimination contrary to the free movement of capital. But that does not mean that the ECJ extended the benefits granted under the non-discrimination provision of a tax treaty to residents of EU Member States on the basis of the fundamental freedoms. The Court only decided that it is contrary to those freedoms to impose additional requirements on non-residents in order for the exemption to apply, if those additional requirements are not justified. Here, the Court held that requiring there to be an instrument of mutual assistance or a non-discrimination clause was not justified because the tax authorities were free to request the necessary information from the taxpayer. That does not mean that the ECJ grants EU residents access to benefits guaranteed under a tax treaty non-discrimination clause.

discussed whether this implies that that other contracting State is entitled to apply retaliatory discrimination. In the context of the ECJ's comparability-test, a different consequence of the concept of reciprocity is at issue. In particular, because bilateral tax treaties are the result of the balance between the conflicting interests of the contracting States, each tax treaty is different. As a result of this unique nature, a taxpayer governed by one tax treaty is not comparable to a taxpayer governed by another tax treaty (assuming that the provision in question cannot be regarded as a benefit separable from the remainder of the Convention, but is an integral part thereof and contributes to its overall balance).

3. Has the possibility of horizontal discrimination been created by the evolution in the ECJ's case law?

It has been suggested that the evolution in the Court's case law since *Gilly* has actually made horizontal discrimination possible[1801]. The basic idea underlying this argument is that, since *Gilly*, the ECJ has considered the OECD MC to be increasingly less important and individual bilateral tax treaties to be more important. *Gilly* illustrates the ECJ's traditional position that, due to a lack of harmonization, the Member States are free to conclude bilateral tax treaties in order to allocate taxing powers. However, the ECJ referred to the OECD MC for the interpretation of individual tax treaty provisions and definitions. What seems especially important to the Court in this respect is that the provisions of the OECD MC and the Commentaries are internationally accepted. This idea was phrased as follows in *Gilly*: *"Nor, in the allocation of fiscal jurisdiction, is it unreasonable for the Member States to base their agreements on international practice and the model convention drawn up by the OECD, Article 19(1)(a) of the 1994 version of which in particular provides for recourse to the paying State principle. According to the commentary on that article, that principle is justified by 'the rules of international courtesy and mutual respect between sovereign States' and 'is contained in so many of the existing conventions between OECD member countries that it can be said to be already internationally accepted'"*[1802]. In *Gilly*, the ECJ thus tested whether the provisions of the treaty between France and Germany were internationally acceptable by referring to the OECD MC and its Commentaries[1803]. In other words, the measure of acceptability of the bilateral treaty at issue was determined by comparison to the OECD MC and the Commentaries, because of their broad international acceptance.

The authors suggesting that horizontal discrimination has been made possible by the evolution of the Court's case law signal that the ECJ has gradually removed references to the OECD MC in its later judgments[1804]. Eventually, the ECJ referred to the OECD MC only as a source of law when a specific bilateral treaty was concluded, instead of referring to the OECD MC as the basis for avoiding double taxation[1805]. In some cases involving tax treaties, no reference at all was made to the OECD MC, not even as regards the international acceptability of the treaty provisions[1806]. These authors argue that this case law, in which the ECJ considered the OECD MC to be increasingly less important, actually made horizontal discrimination possible. As the ECJ gradually considered individual bilateral treaties more important, differentiations became more pronounced because of the absence of harmonisation of tax

[1801] H. VAN DEN HURK and J. KORVING, "The ECJ's judgement in *OESF* – Is horizontal discrimination a threat to the internal market?", *Bull. IBFD* 2009, 101-102.
[1802] C-336/96, *Gilly*, § 31.
[1803] See also C-436/00, *X and Y*, § 54 *et seq.*
[1804] H. VAN DEN HURK and J. KORVING, *o.c.*, 101.
[1805] E.g. C-524/04, *Thin Cap GLO*; C-414/06, *Lidl Belgium*.
[1806] E.g. C-152/03, *Ritter Coulais*; C-376/03, *D*; C-527/06, *Renneberg*.

treaty provisions within the EU. Member States could thus grant favourable treatment in their tax treaties with certain Member States without the obligation to grant the same treatment in their tax treaties with other Member States. Therefore, these authors argue that the ECJ should return to the approach taken in *Gilly*.

However, it is important to stress once again that *Gilly* concerned the allocation of taxing powers in a tax treaty, with the objective of avoiding double taxation. The Court's idea that conformity with the OECD MC and its Commentaries guarantees a certain amount of international acceptability should be seen in that context. The requirement that bilateral treaty provisions must be internationally accepted is only relevant if those provisions require consensus in order to function properly. Consensus is not always relevant in determining the correctness of an idea. For instance, when allocating taxing powers in order to avoid double taxation, it is essential that a concensus is reached on the method of doing so. If a number of States use one method in their bilateral treaties, while a number of other States use a second method in their bilateral treaties, double taxation is inevitable. Only if there is uniformity on the method of allocating taxing powers among States, can double taxation be completely avoided. Thus, the allocation of taxing powers is a clear example of a matter in which the correctness of a position is determined by the degree of consensus. This is precisely the reason why the ECJ attached such great importance to the OECD MC in *Gilly*. Adherence to the OECD MC is a suitable benchmark for the degree of international acceptance of a tax treaty, and, therefore, the degree of consensus reached on the provisions of the treaty. Given the importance of consensus for the allocation of taxing powers, it was logical for the Court to refer to the OECD MC in *Gilly*.

Certain other tax treaty provisions do not require concensus to function. For instance, the allowance granted in the applicable tax treaty in *D* did not require any international acceptance in order for it to operate properly. Similarly, the benefits granted in the tax treaties at issue in *ACT* did not operate any more efficiently if their international acceptance increased.

In other words, the Court has not abandoned its *Gilly*-case law. Instead, it has become increasingly clear that *Gilly* can only be applied to provisions on the allocation of taxing powers. For such provisions, it is clear that international acceptance (which is reflected by the adherence to the OECD MC) is necessary in order to function properly. In contrast, other provisions – e.g. the tax benefits at issue in *D* – do not require international acceptance to operate efficiently.

e. Horizontal comparability if the disadvantage is not caused by a tax treaty?

1. Cadbury Schweppes

Finally, the importance of the applicable tax treaty in these cases should be stressed once more. As mentioned before, the *D*-line of cases is quite complicated, as the different issues overlap significantly. As a result, it is difficult to determine whether the Court refuses to apply a horizontal comparability-test because it feels that the fundamental freedoms are not suited for such an analysis, or simply because the disadvantage in those cases was due to divergent tax treaty provisions. If the latter assumption is correct, then the Court would not hesitate to apply a horizontal comparability-test in cases where **domestic law** distinguishes between different types of cross-border situations.

In *Cadbury Schweppes*[1807], the ECJ examined the U.K. CFC rules. Pursuant to U.K. tax legislation, resident companies were subject to tax in the U.K. to corporation tax on their worldwide profits, including the profits made by branches or agencies outside the U.K. On the other hand, resident companies were not taxed on the profits of their subsidiaries as they arose, nor were they taxed on dividends distributed by a resident subsidiary. They were, however, taxable on dividends distributed by a non-resident subsidiary. In order to prevent double taxation in the latter case, the resident company was entitled to a tax credit up to the amount of tax paid by the subsidiary as the profits arose.

The U.K. CFC rules provided for an exception to the general rule that resident companies were not taxed on the profits of subsidiaries as they arose. The profits of a CFC (a non-resident company in which the resident company owns a holding of more than 50%) were attributed to the resident company and taxed in its hands. A tax credit was granted to the resident company for the tax paid by the CFC in its State of residence. If those same profits were then distributed in the form of dividends to the resident company, the tax paid by the latter in the U.K. was treated as additional tax paid abroad by the CFC, which gave rise to a tax credit payable in respect of the tax owed by the resident company on those dividends. The CFC legislation applied when the CFC was subject in its State of residence to a 'lower level of taxation', which was the case in respect of any accounting period in which the tax paid by the CFC was less than three quarters of the amount of tax which would have been paid in the U.K. if the profits of the CFC had been taxed there.

CS, a U.K. resident company, was the parent company of a group of companies (the Group) which consisted of companies established in the U.K., in other Member States and in third States. That group included, inter alia, two subsidiaries in Ireland, CSTS and CSTI, which CS owned indirectly through a chain of subsidiaries at the head of which was CSO, a U.K. resident company. CSTS and CSTI, which were established in the International Financial Services Center in Dublin (IFSC), were subject to a tax rate of 10% at the material time. Given the tax rate applicable to CSTS and CSTI, their profits were subject to 'a lower level of taxation' within the meaning of the U.K. CFC legislation. The U.K. tax authorities thus claimed from CSO, the first U.K. resident company in the group chain, corporation tax on the profits of CSTI. The tax notice related only to the profits of CSTI because, in the financial year concerned, CSTS made a loss.

The question arose whether the U.K. CFC legislation was contrary to the freedom of establishment. The alleged discrimination was of a dual nature. First, the U.K. CFC rules introduced a difference in treatment of cross-border investments as compared to domestic investments (vertical discrimination). Secondly, the U.K. rules also differentiated between investments in low tax Member States and investments in Member States with a higher tax burden (horizontal discrimination).

This dual nature was acknowledged by Advocate-General Léger in his opinion in *Cadbury Schweppes*. Interestingly, the referring court had expressly asked first whether the U.K. legislation should be seen as a restriction or as discrimination[1808]. It seems as if the Advocate-General is of the opinion that the measure at issue is a restriction (§ 84 of the opinion: *"I shall now consider whether that restriction can be justified"*), but his entire analysis is discrimination-based (comparability-test: § 78-80; disadvantage-test: § 74-77; justification-

[1807] C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue*, 12 September 2006.
[1808] C-196/04, *Cadbury Schweppes*, § 24.

test: § 85 *et seq*.). Moreover, the measure itself is clearly discriminatory: investments in certain Member States are placed at a disadvantage as compared to investments in other Member States or domestic investments. The restriction (i.e. the fact that residents are deterred from investing in low-tax Member States) is precisely the result of this difference in treatment[1809]. As a result, the distinction between discrimination and restriction is of no use, as they go hand in hand: the restriction is the result of the discrimination.

More importantly, however, the Advocate-General expressly adresses the vertical and the horizontal discrimination. As to the vertical aspect, the A.-G. observes that a resident company with a resident subsidiary is never taxed on the profits of that subsidiary. In contrast, a resident company with a subsidiary in a low-tax Member State is taxed on the subsidiary's profits as they arise. As to the horizontal aspect, the A.-G. states that a resident company with a subsidiary in a Member State which does not have a sufficiently favourable regime to fall within the scope of application of the CFC legislation is not taxed on the profits of that subsidiary as they arise. That resident company cannot be taxed until those profits are paid to it in the form of dividends. In contrast, a resident company with a subsidiary in a low-tax Member State is taxed on the subsidiary's profits as they arise[1810].

The U.K. had argued that such a horizontal comparison was impossible, but the Advocate-General disagreed: *"I take the view that the assessment of the compatibility with Community law of the legislation in question must examine all the ramifications of that legislation. As we know, 'discrimination' is defined as the application of different rules to comparable situations or the application of the same rule to different situations. The only question to be asked in order to determine whether different treatment of two situations is discriminatory is therefore whether those two situations are comparable."* In this respect, the A.-G. decides that CS could be compared to a resident company which has established a subsidiary in another Member State having a less favourable tax regime than that in effect in the IFSC because, *"in either case, a United Kingdom resident company has established a subsidiary in another Member State"*[1811]. In other words, the relevant characteristic of both situations is the establishment of a subsidiary in another Member State. Other considerations are irrelevant.

As a counter-argument, it was submitted that the disparity in the rates of corporation tax in effect within the EU rendered the situations incomparable. The Advocate-General refutes this idea by pointing out that it would be tantamount to conceding that a Member State is entitled to choose the other Member States in which its domestic companies may establish subsidiaries with the benefit of the tax regime applicable in the host State. However, such a situation would *"manifestly lead to a result contrary to the very notion of single market"*. Even though the fixing of rates of corporation tax falls within the unfettered competence of each Member State, the freedom of establishment confers on every company the right to set

[1809] As confirmed in § 75 of the Advocate-General's opinion: *"We have, therefore, differentiated tax treatment which places at a disadvantage companies which, like Cadbury, have established a subsidiary in Ireland, in the International Financial Services Centre, and such treatment is indeed such as to deter a resident company from exercising its right of establishment there."*

[1810] A very plain indication that the Advocate-General considers there to be a clear distinction between the horizontal and vertical discrimination in *Cadbury Schweppes* (as opposed to the Court: cf. infra) can be found in § 77 of his opinion. There, the A.-G. observes that, even if no difference in treatment existed in the vertical relationship, *"that would not call into question the existence of unequal treatment and the disadvantage to Cadbury in comparison with the position of a resident company which has established a subsidiary in another Member State which has a less favourable tax regime than that in effect in the International Financial Services Centre."*

[1811] Opinion of Advocate-General Léger in C-196/04, *Cadbury Schweppes*, 2 May 2006, § 78.

up a subsidiary in the place of its choice within the EU. Therefore, a Member State may not treat differently its resident companies which establish subsidiaries in other Member States depending on the tax rate applicable in the host State. Finally, that interpretation would also run counter to the approach adopted by the Court in *Eurowings* and *Barbier,* in which it was held that low taxation applicable in a Member State cannot justify unfavourable tax treatment by another Member State and that an EU national cannot be deprived of the right to rely on the fundamental freedoms on the ground that he is profiting from tax advantages which are legally provided by the rules in force in a Member State other than his State of residence[1812].

Put briefly, the Advocate-General finds horizontal discrimination to be equally detrimental to the internal market as vertical discrimination. He does not consider the comparison between two cross-border situations to be impossible: the relevant characteristic is exactly their exercise of the freedom of establishment and the difference in tax rates between the Member States is not a relevant difference between the situations.

Unfortunately, the ECJ itself was not quite as unequivocal as the Advocate-General. The Court started its analysis by observing that the U.K. CFC legislation entailed different treatment of resident companies on the basis of the level of taxation imposed on the company in which they have a controlling holding. However, the ECJ does not draw a clear distinction between the vertical and the horizontal aspect of the discrimination. Apparently, the Court sees a difference in treatment between, on the one hand, a resident company with a CFC in a low-tax Member State (in which case the CFC legislation is applicable) and, on the other hand, a resident company with a controlled company in the U.K. or with a CFC in a non-low-tax Member State (in which case the CFC legislation does not apply). In other words, the Court does not distinguish the vertical aspect (i.e. the difference in treatment between the subject of comparison and a comparable internal situation) from the horizontal aspect (i.e. the difference in treatment between the subject of comparison and a comparable cross-border situation). The reason for this is not entirely clear. If the Court wanted to make clear that horizontal comparisons are impossible, it could have said so, or simply restrict itself to the vertical aspect. On the other hand, it is not certain whether the horizontal aspect in itself would have been sufficient to consider the measure as being discriminatory. Perhaps the Court sees the vertical and the horizontal aspect as a 'single composite infringement' on the freedom of establishment, as it did in § 42-43 of *Saint Gobain*. In any event, by joining both issues into one single question, the Court avoided the tricky question as to the possibility of horizontal comparisons[1813].

After *Cadbury Schweppes*, other Advocate-Generals have taken a position similar to that of A.-G. Léger, particularly Advocate-General Bot in *Orange European Smallcap* (see supra) and Advocate-General Mengozzi in *Columbus Container Services* (see hereafter).

[1812] Opinion of Advocate-General Léger in C-196/04, *Cadbury Schweppes*, 2 May 2006, § 79-81.
[1813] Similarly, it could be suggested that by joining two issues in *Saint Gobain*, the Court side-stepped the problem of having to define the difference between restriction and discrimination: see supra.

2. Columbus Container Services[1814]

The *Columbus Container*-case concerned German quasi-CFC rules which triggered a switch-over from the tax treaty exemption to a tax credit if a PE in the other contracting State was subject to a low tax burden there. Similarly to *Cadbury Schweppes*, the end-result was that the PE underwent the same tax treatment it would have if it had been set up in Germany.

Under German tax law at the material time, German residents were subject to tax on their worldwide income. An entity regarded as a partnership under German law was not as such subject to tax. The profits made by a partnership, either in Germany or elsewhere, were assigned pro rata to the partners residing in Germany and the partners were taxed on their own profit in accordance with the principle of tax transparency of partnerships. This attribution of the profits of a partnership to its partners applied even if the partnership was liable, as such, to corporation tax abroad, in the State in which it was registered.

Columbus was a limited partnership governed by Belgian law, which had its registered office in Belgium. Under German law, Columbus was regarded as a partnership. In Belgium, Columbus was regarded as a coordination centre (which meant that the tax base for profits made in Belgium was determined at a standard rate in accordance with the 'cost-plus' method). Columbus' shares were held by German residents. Columbus was taxed by the Belgian tax authorities at the rate applicable to coordination centres, with taxation amounting to less than 30% of the profits.

Under Article 7(1) of the tax treaty between Germany and Belgium, the profits of a German undertaking carrying out its activities through a PE in Belgium, such as a limited partnership, were taxable in Belgium to the extent to which they were attributable to that PE. As limited partnerships were liable to corporation tax under Belgian tax law, the tax treaty treated the distribution of profits as dividends. Under Article 23(1)(1) of that treaty, the income of a German resident, derived from and taxable in Belgium pursuant to the tax treaty, was exempt from tax in Germany.

Contrary to the provisions of the tax treaty, German anti-abuse legislation provided for a switch-over from the exemption method to the credit method. In particular, since the German CFC-rules did not cover branch profits, a specific anti-abuse measure in German tax law provided that, in respect of passive investment income from PEs in a low-tax jurisdiction, double taxation was avoided by offsetting the taxes levied abroad on that income rather than by way of exemption. Under German tax law at the material time, taxation was low if profits were taxed at a rate of less than 30%.

Applying these domestic rules, the German tax administration taxed the partners in respect of Columbus' profits, thereby setting the amount of tax paid in Belgium off against those profits. According to Columbus, the switch-over from exemption to credit-method violated the freedom of establishment because it rendered cross-border establishments less attractive. The German government countered by arguing that the German measure restored equal treatment between cross-border situations such as that at issue in *Columbus* and purely domestic

[1814] C-298/05, *Columbus Container Services BVBA & Co. v Finanzamt Bielefeld-Innenstadt*, 6 December 2007. See also R. MIGGLAUTSCH, "Rs Columbus Container Services - Doppelbesteuerungsabkommen und Gemeinschaftsrecht", *Ecolex* 2008, 265-267; F. OCHS, "Keine Beschränkung der Grundfreiheiten durch § 20 Abs. 2 AStG", *European Law Reporter* 2008, 88-92.

situations. More specifically, the German rules were intended to achieve tax neutrality, i.e. identical tax treatment irrespective of the location of the investment.

The opinion of Advocate-General Mengozzi

Advocate-General Mengozzi started his analysis by observing that *Cadbury Schweppes* was of particular interest to the *Columbus*-case. The A.-G. specifically stresses that in *Cadbury Schweppes* the Court applied both a vertical and a horizontal comparison. He continues: *"As [Cadbury Schweppes] illustrates, determination of the (objective) comparability of situations is of fundamental importance in assessing whether application of a national measure fails to uphold the equal treatment that must in principle be ensured between those situations and, hence, whether that measure is liable to restrict freedom of establishment. […] It is therefore necessary in my view to consider the tax treatment of the income and capital of the partners in Columbus as compared, on the one hand, with that of the partners in a partnership who have not exercised their right of freedom of movement (domestic situation) and, on the other hand, the tax treatment of the income and capital of the partners in a partnership who have exercised their right of freedom of establishment in a Member State where the level of taxation is higher than that provided for by the AStG (cross-border situation)"*[1815]. The remainder of the A.-G.'s opinion is structured along those lines: first he examines whether the German rules discriminate vertically[1816], next he examines whether they discriminate horizontally[1817].

As to the vertical aspect, the A.-G. decides that no discrimination arises, because there is no disadvantage for Columbus' partners as compared to a comparable domestic situation (this aspect of the opinion will be discussed in 2.E.I.B.b.2). As to the horizontal aspect, the A.-G. starts his analysis with an extensive discussion of the Court's decision in *Cadbury Schweppes,* particularly the horizontal aspect thereof. The Advocate-General thus notes that the premiss taken by the Court in *Cadbury Schweppes* as the basis for its description of the U.K. CFC legislation as being contrary to the freedom of establishment was not only a traditional (vertical) comparison between a cross-border situation and a domestic situation. It was also based on *"a more original comparison between two cross-border situations, depending on whether the resident company has set up a controlled company in a Member State other than the United Kingdom, applying a level of taxation that is lower or higher than that provided for by the United Kingdom legislation on CFCs"*.

According to the A.-G., the reason for the introduction of that horizontal aspect originates most likely from A.-G. Léger's opinion in *Cadbury Schweppes*[1818]. According to Advocate-General Mengozzi, the risk of fragmentation of the common market[1819] generated by national

[1815] Opinion of Advocate-General Mengozzi in C-298/05, *Columbus Container*, 29 March 2007, § 67-71.
[1816] Opinion of Advocate-General Mengozzi in C-298/05, *Columbus Container*, § 72-108.
[1817] Opinion of Advocate-General Mengozzi in C-298/05, *Columbus Container*, § 109-156.
[1818] Opinion of Advocate-General Mengozzi in C-298/05, *Columbus Container*, § 110-116, referring to Advocate-General Léger's Opinion in *Cadbury Schweppes*, § 78-83.
[1819] The idea that the internal market requires a prohibition of market fragmentation might be inspired by the ECJ's case law on competition (e.g. C-56/65, *Société Technique Minière v Maschinenbau Ulm GmbH*, 30 June 1966, *ECR* 1966, 00235, 249, where the Court held that the Treaty rules on competition prohibited measures that were *"capable of bringing about a partitioning of the market in certain products between Member States and thus rendering more difficult the interpenetration of trade which the Treaty is intended to create"*) and Advocate-General Van Gerven's opinion in *Torfaen*, where he observed that this prohibition of market partitioning (or compartmentalization) should not only apply to agreements between private parties under the Treaty rules on competition but also to measures taken by the Member States under the free movement of goods (Opinion in C-145/88, *Torfaen Borough Council v B & Q plc.*, 29 June 1989, *ECR* 1989, 03851, § 21-24). See

provisions such as the U.K. CFC legislation lies at the origin of the Court's acceptance of horizontal comparability. The A.-G. does not find that solution to be open to criticism in itself. Moreover, it is *"consistent with the existence of an internal market which, under […] Article 3(1)(c) EC, is a feature of the Community's activities"*[1820]. Consequently, a Member State of residence cannot restrict the freedom of establishment of its nationals to part of the common market. Thus, the obligation on the State of residence is to ensure, in addition to respect for equal treatment among its residents as regards whether they have or have not exercised their freedom of movement, that they are not deterred from establishing themselves in the Member State of their choice, inter alia by means of tax measures[1821].

However, he immediately observes that this approach raises the question whether the vertical and horizontal test used by the Court in *Cadbury Schweppes* are to be used individually or cumulatively. In other words, the question could be raised as to whether a difference in treatment, provided for by the national legislation of the taxpayer's Member State of residence, which applies solely between two cross-border situations is sufficient in order to consider that the freedom of establishment has been violated. Or, conversely, it could be suggested that horizontal discrimination is only sufficient if there is at the same time vertical discrimination (which would effectively render the concept of horizontal discrimination redundant). On the basis of Advocate-General Léger's opinion in *Cadbury Schweppes* and § 44-45 of the Court's judgment in that case, A.-G. Mengozzi considers that horizontal discrimination in itself is sufficient to constitute a violation of the freedom of establishment. In particular, the fact that in § 44-45 of *Cadbury Schweppes* the Court used the conjunction 'or' when it identified the two situations in the light of which the position of the resident company subject to the U.K. CFC legislation should be compared (i.e. vertically 'or' horizontally), supports this view.

As to the comparability-test, the German government contended that the situations at issue in *Columbus* were not comparable, thereby referring to the Court's reasoning on comparability in *D* (cf. supra). The Advocate-General dismisses this argument in two steps. First, he refers to *Cadbury Schweppes*, in which the Court accepted the horizontal comparability between a U.K. resident parent company with a subsidiary in a low-tax Member State and a U.K. resident parent company with a subsidiary in another Member State. Secondly, the A.-G. notes that the German government's argument seems to suggest that if the horizontal comparability were to be accepted, it would mean that where a Member State applies the exemption method under a tax treaty as regards taxation of income derived by its nationals from a PE located in another Member State, that State would also be bound to apply the exemption method in its relations with all the other Member States in respect of the same type of income. Referring to *D* and *Saint-Gobain*, the A.-G. indicates that the Court's case law is less clear than the German government appears to contend. Advocate-General Mengozzi explains the difference between *Saint-Gobain* on the one hand and *D* and *ACT* on the other hand by stressing that *Saint-Gobain* concerned the comparison between residents and non-residents whereas *D* and *ACT* concerned the comparison of two different types of non-residents, one of whom was entitled to tax treaty benefits. From this, the A.-G. concludes that Germany could not argue that its own residents, which are in principle taxed on the basis of their worldwide income in Germany, are in an objectively different situation depending on

---

also A. CORDEWENER, "EC law protection against horizontal tax discrimination on the rise – or how to play snooker in an Internal Market", *EC Tax Review* 2007, 211.

[1820] Opinion of Advocate-General Mengozzi in C-298/05, *Columbus Container*, § 118.

[1821] Opinion of Advocate-General Mengozzi in C-298/05, *Columbus Container*, § 133.

whether they receive income derived from a Member State where the level of taxation is lower or higher than the rate provided for in German tax law[1822].

Although this second element in the A.-G.'s reasoning seems to be beside the point (and might even be interpreted as suggesting a vertical comparison), it should be stressed that this argument serves the specific purpose of refuting one particular aspect of the German government's line of reasoning. Specifically, the German government supported its claim that the situations were not comparable by referring to *D*, which could be read as precluding the extension of tax treaty benefits to persons not covered by the scope of the tax treaty. By contrasting *D* with *Saint-Gobain*, it seems that the Advocate-General tries to demonstrate that such an extension is not always impossible. Given the comparability of the situations (which is established in the first step of the A.-G.'s opinion, on the basis of *Cadbury Schweppes*), the partners in *Columbus* are entitled to the benefit of the exemption method, as other non-residents are. The second step in the A.-G.'s reasoning serves to demonstrate that this entitlement is not precluded by a general refusal of the Court to extend tax treaty benefits to persons not covered by its scope.

Finally, the Advocate-General addresses the question whether the Court's reasoning in *Cadbury Schweppes* that horizontal discrimination is contrary to the freedom of establishment can be transposed to *Columbus*, given the specific purpose of the German measure at issue in the latter case (i.e. the avoidance of double taxation). According to the A.-G., this purpose does not change the fact that German taxpayers are deterred from establishing themselves or maintaining an establishment in a Member State where the level of taxation is lower than that provided for by German tax law. Accordingly, in view of the fragmentation of the internal market caused by the German measure, such a measure is incompatible with the freedom of establishment, unless it is justified[1823].

The decision of the ECJ

Given the facts of the case and the Advocate-General's lucid line of reasoning, it would seem that *Columbus* was the perfect opportunity for the ECJ to clarify its position on horizontal discrimination. However, the Court did not seize this opportunity.

In response to Columbus' argument that the German measure lead to a distortion of the choice that companies and partnerships have to establish themselves in different Member States, the Court noted that *"in the current state of harmonisation of Community tax law, Member States enjoy a certain autonomy. It follows from that tax competence that the freedom of companies and partnerships to choose, for the purposes of establishment, between different Member States in no way means that the latter are obliged to adapt their own tax systems to the different systems of tax of the other Member States in order to guarantee that a company or partnership that has chosen to establish itself in a given Member State is taxed, at national level, in the same way as a company or partnership that has chosen to establish itself in another Member State"*[1824].

The Court thus seems to dismiss the possibility that horizontal discrimination is contrary to the Treaty freedoms, but the reason for doing so is far from clear. By referring to the autonomy of Member States in tax matters, the Court seems to suggest that the issue of

[1822] Opinion of Advocate-General Mengozzi in C-298/05, *Columbus Container*, § 134-144.
[1823] Opinion of Advocate-General Mengozzi in C-298/05, *Columbus Container*, § 145-148.
[1824] C-298/05, *Columbus Container Services*, § 51.

horizontal discrimination falls outside the scope of the freedoms, similarly to disparities. This is puzzling. There is no reason why the Court should refuse to address matters of horizontal discrimination. As mentioned earlier, the fragmentation of the market resulting from horizontal discrimination is incompatible with the very idea of a common market. Moreover, in cases such as *Columbus*, it is very clear that the disadvantage is caused by the tax system of one Member State, rather than by the interaction of different systems. Given the earlier case law, one would have expected the Court to address the issue at the level of comparability, but the analysis is cut short before that stage. This outright refusal to apply the fundamental freedoms in *Columbus* might be an indication that the Court considers those freedoms to be based on the idea of national treatment, rather than on the prohibition of any form of discrimination. As mentioned earlier, such an interpretation is difficult to reconcile with the idea that the freedoms aim to achieve the furthering of the internal market.

f. Conclusion

The Court's case law on horizontal discrimination can be divided into two categories. A first category, illustrated by *D*[1825], involves an advantage which is granted **under a tax treaty** to one category of non-residents but not to another category of non-residents. The test proposed in *D* consists of verifying whether the tax treaty provision at issue is a benefit separable from the remainder of the treaty or, conversely, whether it is an integral part thereof and contributes to its overall balance. In the latter case, the different categories of non-residents are not comparable, which means that the disadvantage is not discriminatory. In the former case, the situations are comparable, which means that the other steps of the discrimination-analysis have to be applied.

Secondly, *Orange European Smallcap* and *Cadbury Schweppes* suggest that **domestic** measures that differentiate between categories of non-residents may be contrary to the fundamental freedoms. Unfortunately, the Court did not seize the opportunity to confirm this position in *Columbus Container*, which means that some uncertainty remains as regards this category of cases. Due to the brevity of the ECJ's analysis in *Columbus*, it is unclear whether the Court just considered the two cross-border situations incomparable in that specific case or whether it has given up on making horizontal comparisons[1826].

In any event, horizontal discrimination is equally detrimental to the internal market as vertical discrimination. There is no reason why market fragmentation due to benefits granted by a Member State to residents of a specific other Member State should be treated differently from obstacles arising where a Member State grants benefits exclusively to its own residents. Consequently, there is no reason for the Court to apply a different analysis to vertical cases (e.g. *Saint Gobain*) and horizontal cases (e.g. *ACT*). If the fundamental freedoms are to be interpreted as instruments for furthering the realization of the internal market, both types of discrimination should be subject to the same analysis and both should be removed if they are not justified. In other words, the fundamental freedoms should be read as including an MFN-obligation, meaning that a Member State cannot give preferential treatment to residents of a second Member State as compared to residents of a third Member State[1827]. Where such preferential treatment is provided for in domestic law, it should be struck down under the

[1825] And by the first tax treaty issue in *ACT*, i.e. the aspect not concerning the LOB clause (see 2.E.I.A.b.9.b).
[1826] See M. LANG, "Recent case law of the ECJ in direct taxation: trends, tensions and contradictions", *EC Tax Review* 2009, 106, who argues that the Court has not yet given up on making horizontal comparisons.
[1827] See also A. CORDEWENER and E. REIMER, "The future of most-favoured nation treatment in EC tax law – Did the ECJ pull the emergency brake without real need? Part I", *European Taxation* 2006, 244-246.

fundamental freedoms. So it is unfortunate that the ECJ is very reluctant to do so, as *Columbus Container* illustrates.

The same principle also applies where the preferential treatment is provided for in a tax treaty, but the bilateral nature of such treaties complicates the analysis. As noted above, the Court has taken account of that bilateral nature by distinguishing between provisions that contribute to the overall balance of the tax treaty and provisions that are separable from the remainder of the treaty. Additionally, where the disadvantage is due to a tax treaty provision that merely allocates taxing powers between the contracting States, the issue goes beyond the scope of application of the fundamental freedoms (*Gilly*). The latter point is entirely correct: given the sovereignty in matters of direct taxation, the ECJ cannot rule on measures concerning the allocation of taxing powers. But the Court's position on other tax treaty provisions is open to criticism.

A first possible point of criticism is that the reasoning with respect to comparability seems to be circular. But that criticism would be incorrect. Obviously, arguing that a non-resident is not entitled to tax treaty benefits to which another non-resident is entitled because the situations are not comparable, and then stating that the situations are not comparable precisely because the former non-resident is not entitled to that benefit while the latter is, is circular[1828]. But that is not what the Court does. The reason the Court gives for incomparability is **not** that the subject of comparison is not entitled to the treaty benefit at issue, but that the subject of comparison is not a resident of a State party to the tax treaty and that a non-resident of a contracting State is incomparable to a resident of a contracting State. Those are two different things and it is important to distinguish them.

Compare this to the normal, vertical analysis. There, the subject of comparison, a non-resident, claims entitlement to a benefit granted excusively to residents of the discriminating State. The starting position in such cases is that residents and non-residents are not comparable, which means that it is, in principle, not discriminatory to restrict the benefit to residents. Clearly, that is not the same as saying that the situations are incomparable simply because the subject of comparison is not entitled to the benefit claimed while the object of comparison is so entitled. Instead, the **reason** why the subject of comparison is not entitled to that benefit is because he is a non-resident and, in principle, residents and non-residents are generally not comparable given their different ability to pay in the State concerned. The same is true in the horizontal analysis. There, the reason for the incomparability is that the subject of comparison is not a resident of a State party to the tax treaty. Furthermore, non-residents of a contracting State are generally not comparable to residents of a contracting State, not because of their different ability to pay, but because the scope of application of a tax treaty is inherently subject to the principle of reciprocity. That is to say, a contracting State agrees to grant certain benefits to the residents of the other contracting State because the latter State also grants certain benefits to the residents of the first contracting State. So the scope of application of the tax treaty is subject to a certain balance, and that balance could be upset by extending the benefits granted in the treaty to residents of third State.

Consequently, the reasoning on which the Court bases its conclusion is not circular. However, the underlying argument, that residents of a third State are not comparable to residents of a contracting State because of the balance and reciprocity of the tax treaty, may be

[1828] As noted above, that is not entirely certain with respect to *D* because the taxpayer in that case actually claimed entitlement to a benefit granted under domestic law. In *ACT*, however, it was clear that the taxpayer claimed entitlement to the tax treaty provision itself.

questionable. It is true that benefits provided for in a tax treaty are inherently reciprocal (see supra), but it is unclear why that should affect the horizontal comparison[1829]. As noted above, the Court has consistently held in vertical situations that the non-discrimination obligation must not be made subject to a condition of reciprocity. Furthermore, it held in *Saint-Gobain* that the balance and reciprocity of the applicable tax treaty would not be upset if Germany unilaterally extendend the benefit provided for in that treaty because *"such an extension would not in any way affect the rights of the non-member countries which are parties to the treaties and would not impose any new obligation on them"*[1830]. There is no reason why the conclusion should be different in horizontal cases: if there are no obligations imposed on the third State, why would the balance of the tax treaty be affected? That is to say, what is the difference between unilaterally extending the benefits of a tax treaty from residents to non-residents and unilaterally extending such benefits from non-residents to other non-residents?

Worded differently, the issue discussed here can be solved in two ways. Either it is accepted that the fundamental freedoms imply that the scope of application of tax treaties concluded between a Member State and a third State (or another Member State) is extended to all EU citizens. Clearly, that would compromise the balance of the tax treaty and would run counter to its reciprocal nature. But there is also a second solution, namely that the Member State in question unilaterally extends the benefits provided for in a tax treaty to EU citizens. Such an extension would in no way affect the balance or reciprocity of the tax treaty and would ensure that the horizontal discrimination is removed[1831]. But for some reason, the Court only takes account of that second solution in vertical situations (e.g. *Saint-Gobain*) and not in horizontal situations.

To summarize, the fundamental freedoms should be read as containing an MFN-requirement, both as regards domestic provisions and as regards tax treaty provisions (i.e. through a unilateral extension). However, that requirement is significantly limited as regards tax treaty provisions because provisions concerning the allocation of taxing powers fall outside the scope of the fundamental freedoms. For instance, a treaty provision that limits the amount of withholding tax that a source State can apply to outbound dividends (and, more generally, any treaty provision in line with the distributive rules of Art. 6-22 OECD MC) cannot be extended on the basis of this MFN-requirement. But for other tax treaty provisions, for instance the benefit at issue in the *D* case, there is no reason why MFN treatment should be dismissed.

If the fundamental freedoms indeed require MFN-treatment, it would seem logical that the same comparability- and disadvantage-test applies as in vertical situations. The only difference is that the comparison is no longer between a resident and a non-resident (or a resident exercising his fundamental freedoms and a resident not doing so), but between two non-residents. Consequently, since the comparison is between two non-residents, the starting point is that they are comparable, particularly where the source State subjects both non-residents to the same tax treatment. Subsequently, it would have to be determined whether

[1829] See also A. CORDEWENER, G. KOFLER and S. VAN THIEL, "The clash between European freedoms and national direct tax law: public interest defences available to the Member States", *Common Market Law Review* 2009, 1985-1986.
[1830] C-307/97, *Saint Gobain*, § 58-59. Similarly in C-55/00, *Gottardo*, § 37: *"The unilateral extension by the Italian Republic, to workers who are nationals of other Member States, of the benefit of having insurance periods which they completed in Switzerland taken into account for the purpose of acquiring entitlement to Italian old-age benefits would in no way compromise the rights which the Swiss Confederation derives from the Italo-Swiss Convention and would not impose any new obligations on that country."*
[1831] See also A. CORDEWENER and E. REIMER, "The future of most-favoured nation treatment in EC tax law – Did the ECJ pull the emergency brake without real need? Part II", *European Taxation* 2006, 296.

there are relevant characteristics that differ between them, so as to render the situations incomparable.

10. The comparability of charitable organisations

a. Stauffer[1832]

A foundation established under Italian law owned immovable property in Germany. Under German tax law, organisations having their seat in Germany that exclusively and directly pursued charitable, benevolent or other religious objects were exempt from corporation tax. The Italian foundation exclusively pursued cultural objects in the field of musical education and training. It was clear that the foundation pursued charitable objects as defined under German domestic law (which did not require promotion of the interests of the general public to be undertaken for the benefit of German nationals). Because the exemption for charitable organisations did not apply if the organisation had its seat in another Member State, the German tax authorities assessed the foundation to German tax in respect of the rental income from the immovable property situated in Germany. The foundation objected against this assessment, arguing that it was discriminatory.

The German government argued that a charitable foundation with its seat in Germany played an active role in German society and performed duties which would otherwise have to be carried out by local or national authorities, which would be a burden on the State budget. Therefore, they were not comparable to charitable foundations having their seat in another Member State, since the charitable activities of the latter only concerned the other Member State. Moreover, the conditions under which Member States confer charitable status on a foundation, which entails the grant of tax benefits and other privileges, varies from one Member State to the other, according to each State's conception of public utility and the scope given by it to the concept of 'charitable purposes'. As a result, a foundation that meets the requirement imposed by Italian law may not be comparable to a foundation that meets the requirements imposed by German law since it is possible that the requirements applicable in each Member State concerning the conferring of charitable status are different[1833].

The ECJ dismissed these arguments. First, the Court pointed out that Member States are entitled to require a sufficiently close link between foundations upon which they confer charitable status for the purposes of granting certain tax benefits and the activities pursued by those foundations. However, it was clearly irrelevant for the purpose of deciding the case at hand whether such a link existed. Indeed, German law provided that an organisation pursued charitable objects where its activities were directed at the promotion of the interests of the general public in a manner other than for profit, without making a distinction as to whether those activities were carried out in Germany or abroad. The promotion of the interests of the general public did not mean that such measures must benefit nationals or residents of Germany.

Secondly, the Court observed that EU law did not require Member States to automatically confer on foreign foundations recognised as having charitable status in their Member State of origin the same status in their own territory. Member States have a discretion in this regard that they must exercise in accordance with EU law. In those circumstances, they are free to

[1832] C-386/04, *Centro di Musicologia Walter Stauffer*, 14 September 2006.
[1833] C-386/04, *Stauffer*, § 33-35.

determine which interests of the general public they wish to promote by granting benefits to associations and foundations that pursue objects linked to such interests in a manner other than for profit. However, where a foundation that is recognised as having charitable status in one Member State also satisfies the requirements imposed for that purpose by the law of another Member State and where its object is to promote the very same interests of the general public, the authorities of the latter Member State cannot deny that foundation the right to equal treatment solely on the ground that it is not established in its territory[1834].

In the case at hand, the Italian foundation pursued charitable objectives as defined in German law and also satisfied the requirements to qualify for exemption from corporation tax in Germany. As a result, the Italian foundation was comparable to a German charitable foundation, with the result that it was discriminatory for the German tax authorities to refuse to grant the exemption.

Most of the justification grounds brought forward were dismissed by the Court in brief terms, but the fiscal cohesion argument deserves some closer attention. The German government argued that the effect of the exemption as regards German foundations was to remove liability to tax in respect of activities devoted to the public interest pursued by charitable foundations. In so far as such foundations assume direct responsibility for the common good, they act as substitute for the State, which may, in return, grant them tax benefits without breaching its obligation of equal treatment. In other words, the German government contended that there was cohesion between the tax exemption and a task carried out for the common good. This argument is quite original: it seems to assume that cohesion consists of the relationship between a benefit granted by the government (in the form of a tax advantage) and a corresponding burden shouldered for the community as a whole. Traditionally, that burden has been conceived as a corresponding taxability, but the German government transposes this to tasks carried out for the common good.

> In fact, this cohesion-argument is identical to the first ground for incomparability brought forward by the German government in *Stauffer*: since German charitable foundations performed duties which would normally be carried out by the German government and foreign charitable foundations did not, they were incomparable. This argument was also relied on in the comparability-analysis in *Persche* (see hereafter).

Given the evolution in the Court's attitude towards fiscal cohesion, it should come as no surprise that this argument was dismissed. First, the Court points out that the tax advantage (i.e. the exemption from tax on rental income) did not correspond to a tax levied on German foundations. Accordingly, there was no direct link, from the point of view of the tax system, between the exemption and the offsetting of that advantage by a particular tax levy. The Court thus dismisses the German government's view that fiscal cohesion should be seen in a more general way, as allowing a tax advantage to be offset by other types of burdens shouldered for the common good, apart from tax levies. Secondly, the Court notes that *"the desire to grant the tax exemption only to charitable foundations which pursue the policy objectives of that Member State may, prima facie, appear legitimate"*. However, it was clear in the case at hand that the tax advantage granted to German foundations was not based on the idea that measures promoting the interests of the general public had to benefit the German general public (see supra)[1835].

[1834] C-386/04, *Stauffer*, § 36-40.
[1835] C-386/04, *Stauffer*, § 55-57.

b. Persche[1836]

The taxpayer was a German resident who made a gift to a retirement home in Portugal. Under German tax law, taxpayers were entitled to a tax deduction if they made gifts to promote charitable purposes and purposes recognised as particularly worthy of support. A body was considered to carry on its activities for charitable purposes if its activities were intended to promote the interests of the general public, for example by supporting children or elderly people. The deduction only applied for gifts made to bodies established in Germany. The recipient of the gift had to complete an official form which, for the purposes of the donor's assessment to income tax, was sufficent evidence that the recipient of the gift satisfied the statutory requirements. Accordingly, when assessing the donor to tax, it was not up to the tax authorities to check the recipient's compliance with those requirements. Since Mr Persche's gift was not made to a body established in Germany, he was not entitled to the tax deduction, even though he supported his claim with evidence that the Portuguese recipient of the gift was entitled to all exemptions and tax benefits conferred by Portuguese law on charitable bodies. The question arose whether this distinction fell foul of the free movement of capital.

As to the comparability-issue, the German government contended that foreign charitable bodies were not comparable to German charitable bodies for two reasons. First, Member States may apply different concepts of benevolence as well as different requirements for recognition of acts of benevolence and they are not in a position to monitor compliance with these requirements as regards foreign bodies. Secondly, if a Member State abstains from levying taxes by exempting gifts made to charitable bodies established in that State, that is because such bodies absolve that Member State of certain charitable tasks which it would otherwise have to fulfil itself using tax revenues[1837].

The latter point is quite similar to the cohesion argument brought forward in *Stauffer* (see supra), but framed in terms of comparability. In *Persche*, The Court does not seem to dismiss this idea entirely: it points out that by encouraging taxpayers, with the prospect of a tax deduction for gifts made to charitable bodies, a Member State encourages such bodies to develop charitable activities for which it usually would take responsibility itself. It is therefore conceivable, according to the Court, that national legislation providing for a tax deduction of gifts to charitable bodies *"could encourage such bodies to substitute themselves for the public authorities in assuming certain responsibilities, and that such assumption could lead to a reduction of the expenses of the Member State concerned capable of compensating, at least partly, for its decreased tax revenues resulting from the right to deduct gifts."* That is less absolute than the statement in *Stauffer* that there was no direct link between the tax benefit and a corresponding tax levy, with the result that the fiscal cohesion argument failed. Even though the argument brought forward in *Persche* is exactly the same, albeit in a different form, the Court seems less reluctant in considering it.

Nevertheless, the Court dismisses the argument on the grounds that a reduction in tax revenue has traditionally been rejected as a justification ground[1838]. More specifically, the German government's argument implies that the 'budgetary compensation' between the tax benefit and the corresponding decrease in tax revenue resulting from the right to deduct gifts can only

[1836] C-318/07, *Persche*, 27 January 2009. See also C-25/10, *Missionswerk Werner Heukelbach v Belgium*, 10 February 2011, concerning succesion duties. Since the Court applied the same comparability-analysis as in *Stauffer* and *Persche*, that case will not be discussed here.
[1837] C-318/07, *Persche*, § 42.
[1838] C-318/07, *Persche*, § 45-46.

occur within Germany. In the case of a foreign charitable body, that body assumes responsibilities which its Member State of establishment would usually assume. As a result, the decrease in tax revenue resulting from the deductibility of gifts would not correspond to a benefit for the common good in Germany.

> It is remarkable that the Court dismisses the German government's incomparability argument by converting it into an argument on decreased tax revenue. It is true that the Court has consistently and correctly dismissed the justification argument that extending a tax benefit to cross-border situations would lead to a decrease in tax revenue, but that is not what the German government's argument came down to. The German government's argument implied that there was a close relationship between the tax advantage (i.e. the tax deduction) and the decrease in public expenses of the Member State because the recipient of the gift assumes responsibilities which would normally be assumed by the public authorities. And since foreign charitable bodies do not assume responsibilities which would normally be assumed by the German authorities, while German charitable bodies do, these bodies are incomparable from the perspective of tax benefits relating to gifts made to them.
>
> As pointed out above, this argument was not only used by the German government in *Stauffer* in the context of fiscal cohesion[1839], but also as an argument for incomparability[1840]. In that respect, the Court recognized that Member States *"are entitled to require a sufficiently close link between foundations upon which they confer charitable status for the purposes of granting certain tax benefits and the activities pursued by those foundations."* However, the argument was ultimately rejected because German law provided that a foundation pursued charitable objective where its activities were directed at the promotion of the interests of the general public, without making a distinction as to whether those activities were carried out in Germany or abroad. As a result, in order for a foundation to qualify for charitable status, it was not necessary for its activities to benefit nationals or residents of Germany. Thus, German law did not presuppose a link between the tax advantage and a corresponding benefit for the German common good (i.e. the fact that the foundation would assume a responsibility of the German authorities and therefore decrease public expenses)[1841]. As a result, this reason for incomparability failed. It would have been preferable had the Court taken the same approach in *Persche* and verified whether there was indeed a relationship between the tax benefit and a corresponding benefit for the German community as a whole.

The ECJ then repeats the position it took in *Stauffer*, that foreign charitable bodies are incomparable to national charitable bodies if the former pursue objectives other than those advocated by the national legislation. Since Member States are free to define the interests of the general public that they wish to promote by granting benefits to bodies that pursue objects linked to such interests in a disinterested manner and comply with the requirements imposed for that purpose, they are not required under EU law to automatically confer on foreign bodies recognised as having charitable status in their Member State of origin the same status in their own territory. However, where a body recognised as having charitable status in one Member State satisfies the requirements imposed for that purpose by the law of another Member State and where its object is to promote the very same interests of the general public, that body is

[1839] C-386/04, *Stauffer*, § 51.
[1840] C-386/04, *Stauffer*, § 33-34.
[1841] Once again, it should be stressed that this argument is very similar to a cohesion argument. And similarly to most cohesion arguments, this one failed because there was no direct link between the tax advantage and a corresponding 'taxation'.

comparable to a national charitable body and should therefore be entitled to the same benefits[1842].

c. Conclusion

The basic tenet of this case law seems to be that a charitable organisation established in Member State A is comparable to a charitable organisation established in Member State B if two conditions are met. First, the State A organisation must meet the requirements for obtaining charitable status in Member State B (e.g. exclusively and directly pursuing charitable objectives). Secondly, the charitable objective pursued by that organisation must also be recognised in Member State B as an interest of the general public which is to be encouraged by tax advantages. If those conditions are not met, the Treaty freedoms do not require a Member State to automatically confer on foreign bodies recognised as having charitable status in their Member State of origin the same status in their own territory[1843].

It is interesting to compare this approach to the approach taken under Art. 24 OECD MC. With respect to non-profit organisations, the Comm. OECD states that Art. 24(1) OECD MC does not require *"a State which accords special taxation privileges to private institutions not for profit whose activities are performed for purposes of public benefit, which are specific to that State, to extend the same privileges to similar institutions whose activities are not for its benefit. […] If a State accords taxation privileges to certain private institutions not for profit, this is clearly justified by the very nature of these institutions' activities and by the benefit which that State and its nationals will derive from those activities"*[1844]. The same argument is repeated with respect to Art. 24(3) OECD MC[1845].

As argued in Part II, 2.B.VIII and Part II, 2.D.III.B.a, the interpretation given in the Commentary is too restrictive. First, the nature of the organisations' activities is not necessarily relevant for the tax measure at issue. As discussed earlier, the relevance of characteristics is essential in determining comparability. So it is incorrect to state as a matter of principle that non-resident (or non-national) organisations are incomparable to resident (or national) organisations because of the nature of their activities. Secondly, the Commentary suggests that non-resident (or non-national) organisations can never be comparable to resident (or national) non-profit organisations because only the latter's activities are to the exclusive benefit of the source State. But there is no reason why a non-profit organisation that carries out activities both to the benefit of its home State and to the benefit of the source State should be treated differently from a non-profit organisation that carries out activities to the exclusive benefit of the source State. For that reason, it might be preferable to take a similar approach to Art. 24 as the approach taken by the ECJ in this context. What is decisive then, is whether the charitable organisation in question pursues objectives that are recognized by the source State as being charitable. If that relevant characteristics is identical, the situations are comparable.

[1842] C-318/07, *Persche*, § 47-50.

[1843] The Court took a similar approach in C-76/05, *Schwarz*, 11 September 2007, § 72-73; C-318/05, *Commission v Germany*, 11 September 2007, § 88-91 and C-10/10, *Commission v Austria*, 16 June 2011, § 31-36, albeit in less clear terms.

[1844] Comm. OECD on Art. 24, paras. 10-13, discussed in Part II, 2.B.VIII.

[1845] Comm. OECD on Art. 24, para. 47, discussed in Part II, 2.D.III.B.a.

c. Conclusions on comparability

Some preliminary conclusions as regards comparability may be drawn from this case law.

I. First, when the Court compares non-residents to residents, the starting point is that they are **not comparable**. Since non-discrimination is based on the concept of horizontal equity, taxpayers are generally considered to be comparable for direct tax purposes when their ability to pay is the same. And because the least imperfect indicator for ability to pay is generally considered to be the taxpayer's income, the underlying reason for this incomparability is that a taxpayer's income is generally centered in his State of residence. This is particularly clear where individuals are concerned (see also hereafter), but it seems that the Court takes the same approach with respect to companies.

Accordingly, when assessing whether discrimination occurs, the ECJ starts from that assumption of incomparability and then starts looking for reasons why the situations might nevertheless be comparable.

(1) With respect to tax allowances relating to personal and family circumstances, a non-resident is comparable to a resident if the former receives no significant income in his State of residence and derives the majority of his taxable income from the source State. The idea behind that argument is that the majority of a taxpayer's income is generally concentrated in his State of residence, with the result that that State is best placed to assess his ability to pay tax, including the taking into account of personal and family circumstances. Yet, when a taxpayer earns (almost) all of his income in another Member State, his State of residence is not in a position to grant him the benefits resulting from the taking into account of those circumstances. In such a situation, that taxpayer is comparable to a resident of the Member State where he earns the majority of his income. That approach has been criticized in 2.E.I.A.b.1.c, where an alternative, 'fractional' approach was considered.

(2) With respect to tax benefits that are not connected to the person of the taxpayer, but to the income earned by that taxpayer (refunds of overpaid wage withholding tax, business expenses, etc.), the Court generally sets aside the basic incomparability of residents and non-residents and considers both categories to be comparable. The reason for that comparability is the fundamental idea underlying the Court's case law on source State taxation that non-residents are comparable to residents with respect to the tax treatment of a certain item of income if the source State exercises its taxing powers as regards both non-residents and residents. That approach was applied, for instance, in *Scorpio*[1846] and in the case law on

[1846] As pointed out in 2.E.I.A.b.7.a, the comparison in *Scorpio* was, strictly speaking, between two categories of residents. However, it is clear from the facts of the case that the discrimination was primarily directed against non-residents since the withholding tax was to be paid on account of the non-resident (see also 2.E.II.C.c, on derivative discrimination). Thus, what was at stake was the less favourable taxation of a non-resident service provider as compared to a resident service provider. The former was subject to a withholding at source while the latter was not. From that perspective, it is clear that the comparison is between a non-resident and a resident. And since the source State taxes both categories of taxpayers in respect of service fees, it is clear that they are comparable as regards a measure concerning the obligation to withhold tax at source. The Court ultimately chose to make the comparison from the perspective of the resident payer of the service fee, but that is of little relevance to the present issue. In other words, non-resident service providers were comparable to resident service providers in the context of the measure at issue in *Scorpio*. Therefore, residents making a payment to a non-resident service provider are comparable to residents making a payment to a resident service provider **as regards the taxation of the service provider**. That is simply the other side of the coin, since it does not concern the taxation of the payer of the service fee, but that of the service provider.

outbound dividends. However, as noted in 2.E.I.A.b.6, the Court's distinction between outbound and inbound dividend cases is not very convincing. It would be more appropriate to use the same relevant characteristic in both situations, namely the susceptibility to double taxation.

Furthermore, the Court has not explained **why** the source State's exercise of taxing powers renders the situations comparable. A first possibility is that this idea refutes the general territoriality-argument. That is to say, where an income-related tax benefit is concerned and the source State taxes a non-resident on the relevant item of income, then that State can no longer maintain that that non-resident is incomparable to a resident on the basis of the different scope of tax liability. Even though residents and non-residents are generally incomparable because of their different scope of tax liability (territoriality), that is no longer the case if the non-resident is taxed on the relevant item of income, since the tax liability of residents and non-residents is identical with respect to the relevant item of income. However, as noted above, territoriality understood as referring to scope of tax liability cannot be seen as an aspect of comparability (see also 2.F.III). Because the scope of tax liability is inherent in the taxpayer's residence, it can only function as a justification ground. Consequently, the rebuttal of that argument – i.e. that the scope of tax liability is identical if the source State taxes both residents and non-residents on the relevant item of income – can only be relied on in the context of justification as well.

A better approach would be to consider the purpose of the domestic measure in each case and then to verify whether the situations are comparable from the perspective of that measure. Obviously, that will generally be the case where income-related benefits are concerned. For instance, where a tax benefit is connected to a specific item of income, a non-resident is comparable to a resident if he earns the same type of income in the Member State in question (i.e. if that State taxes the income). Similarly, with respect to the deductibility of business expenses related to an activity generating taxable income in the source State, non-residents are comparable to residents if the source State taxes that activity. So the Court's approach is generally correct, but it would be preferable if its position were substantiated with a clear argument.

II. (1) In contrast, when the Court compares two categories of residents, the starting point is that these categories are comparable. The reason for that comparability is that there is an assumption that their ability to pay is the same. That is to say, the Court assumes that two residents are comparable on the basis that their income is generally centered in their State of residence.

After ascertaining that basic comparability (whether or not expressly), the Court then addresses whether there are nevertheless reasons why the situations are incomparable. In the context of outbound PE's, for instance, the fact that the PE-income is taxable exclusively in the PE-State does not render the situations incomparable[1847]. Similarly, a resident company is not incomparable to another resident company merely because its parent or subsidiary is situated in another Member State. Against the backdrop of the tax treatment of the resident company in question, that fact will generally be irrelevant (see 2.E.I.A.b.4 and 2.E.I.A.b.5).

[1847] Nevertheless, that aspect may play a decisive role in the justification test. More specifically, *Lidl Belgium* illustrates that a balanced allocation of taxing powers might require the safeguarding of a symmetry between the right to tax profits and the deductibility of losses.

> At first sight, this seems contradictory. As noted above, where a resident and a non-resident are compared, the fact that the source State exercises its taxing power with respect to the income concerned renders the situations comparable. Here, however, the fact that the income is taxable exclusively in the PE-State does not affect the comparability of the situations. But it should be kept in mind that the exercise of taxing powers by the source State in the former situation is only relevant because tax benefits pertaining to a specific item of income are concerned, and not tax benefits pertaining to the taxpayer's overall ability to pay. In contrast, the outbound PE cases all concerned losses. In corporate taxation, losses affect the taxpayer's ability to pay in a smilar way as personal and family circumstances in the context of individual income taxation: both reduce the taxpayer's overall ability to pay tax. In order to take account of the effects which those personal and family circumstances have on an individual's ability to pay tax, States grant certain personal tax benefits to taxpayers. Similarly, in order to take account of the effect which losses have on a company's ability to pay tax, States generally allow the company's taxable income to be reduced by those losses (possibly in different tax years). For that reason, the mere fact that the PE income is taxable exclusively in the PE State does not affect the comparability, since it is not relevant for the taxpayer's ability to pay tax. Of course, it is possible that that aspect comes up for discussion in the justification-test, particularly as a matter of balanced allocation of taxing powers (see e.g. *Lidl Belgium*).

(2) With respect to inbound dividends, the Court generally considers that, in relation to a domestic rule designed to mitigate double taxation of dividends, residents receiving foreign-sourced dividends are comparable to residents receiving domestic dividends since both types of dividends are susceptible to double taxation.

To summarize, the Court's position on comparability seems to be based on a double premise: (1) that direct tax law is generally designed to ensure that taxpayers contribute to public finances in accordance with their ability to pay and (2) that non-discrimination seeks to ensure horizontal equity, i.e. that all taxpayers with the same ability to pay carry the same tax burden. On that basis, the Court thus starts its comparability-analysis by assuming that residents and non-residents are generally incomparable because their ability to pay differs (namely because there is an assumption that the majority of a taxpayer's taxable income is centered in his home State).

However, it is possible that a tax measure is not merely intended to raise public revenue. In particular, tax measures often seek to influence the behaviour of taxpayers by encouraging or discouraging certain acts. From the perspective of such rules, ability to pay is not a relevant characteristic. Instead, the objective of the measure must be scrutinized in order to determine which characteristic determines comparability.

For instance, where a domestic measure tries to encourage a certain charitable objective by granting tax advantages to domestic charitable organisations, then the Court has held that a foreign charitable organisation is comparable to a domestic charitable organisation if the former organisation meets the requirements for obtaining charitable status in the Member State in question and if the charitable objective pursued by the organisation is recognised by that Member State as an interest of the general public which is to be encouraged by tax advantages. A similar approach can be taken where a domestic measure tries to mitigate double taxation on dividends in order to prevent such double taxation from hampering economic development. From the perspective of such a measure's objective, the susceptibility to double taxation is the relevant characteristic. And, as noted above, there is no reason to distinguish in that context between inbound and outbound situations: the relevant characteristic in both categories of cases is the susceptibility to double taxation. In such areas, the (presumed) different ability to pay tax of residents and non-residents is not a relevant characteristic.

I.B. The disadvantage-test

a. Introduction

1. The deceptive simplicity of the disadvantage-test

If two situations are comparable, the principle of non-discrimination demands that the subject of comparison is not treated less favourably. Accordingly, for there to be discrimination, it is essential, first, that the situations are comparable and, secondly, that they are treated differently to the disadvantage of the subject of comparison. Alternatively, if the situations are found to be incomparable, a finding of discrimination requires there to be identical treatment to the disadvantage of the subject of comparison. If this second test turns out to be negative, i.e. if comparable situations are not treated differently or if incomparable situations are not treated identically, there is no discrimination. Finally, the disadvantage incurred by the subject of comparison must be **due to** the distinction (or equal treatment) introduced by the legislation under scrutiny.

At first glance, this test may seem quite straightforward, but its pratical application leads to intricate issues. Take, for instance, the Court's case law concerning the treatment of foreign losses in the taxpayer's home State. This issue may arise in situations where the taxpayer has a PE in another Member State or where he has a subsidiary in another Member State. The ECJ has given decisions with respect to foreign losses in both of those situations, and both categories of case law have been touched upon earlier (for losses incurred by PEs, see 2.E.I.A.b.3.c and 2.E.I.A.b.3.d; for losses incurred by non-resident subsidiaries, see 2.E.I.A.2.4.d). In both situations, the legislation of the taxpayer's home State disallows the taking into account of losses if the corresponding profits are not taxable in that State.

The first question to be addressed is whether the home State legislation makes a distinction on the basis of a cross-border element[1848]. In the cases discussed here, a distinction is made between taxpayers who earn income from another Member State (subject of comparison) and taxpayers who earn all of their income in their home State (object of comparison). Clearly, that is a distinction on the basis of a cross-border element, namely the fact that income is derived from another Member State. Secondly, it should be determined whether those situations are comparable. On the one hand, if the case concerns a taxpayer with a PE in another Member State, the conclusion reached in 2.E.I.A.b.3 applies: a resident taxpayer with a PE in another Member State is comparable to a resident taxpayer who carries on all of his activities in his home State. The tax position of the PE generally does not affect that comparability. On the other hand, if the case concerns a taxpayer with a subsidiary in another Member State, the conclusion reached in 2.E.I.A.b.4.f applies: a resident taxpayer with a subsidiary in another Member State is comparable to a resident taxpayer with a subsidiary in his home State. The incomparability of the resident and the non-resident subsidiary generally does not affect that comparability.

[1848] See 2.E.I.A.a.2, on horizontal comparisons.

Having established that the situations are comparable, the question then turns to the existence of a disadvantage. Clearly, the subject of comparison incurs a disadvantage as compared to the object of comparison, since the latter is able to take all of his losses into account while the former is unable to do so (because the legislation of the home State disallows the taking into account of foreign losses). That is entirely straightforward. However, the decisive question is whether that disadvantage is **due to the legislation of the State whose tax system is under scrutiny**, i.e. the taxpayer's home State. As pointed out earlier, it is not sufficient for a finding of discrimination that a distinction is made between comparable situations and that the subject of comparison is placed at a disadvantage. That disadvantage must also be **due to** the national legislation at issue.

In the context of the taking into account of foreign losses, the answer to that question seems to depend on a more fundamental question, namely whose task it is to take the losses concerned into account. The Court has answered the latter question by stating that the balanced allocation of taxing powers between the Member States implies that the home State is entitled to disallow the deduction of foreign losses. More specifically, that objective may make it necessary to apply to the economic activities of companies established in a Member State only the tax rules of that State in respect of both profits and losses. In effect, to give companies the option to have their losses taken into account in their home State or in another Member State would significantly jeopardise a balanced allocation of the taxing powers between the Member States concerned, as the taxable basis would be increased in one State and reduced in the other State to the extent of the losses transferred[1849]. In other words, it is generally up to the source State to take account of the losses, because the corresponding profits are taxable in that State. However, the situation is different where all the possibilities available in the source State to have the losses taken into account for the tax year concerned and for previous years have been exhausted and where no possibility exists in the source State to carry over the losses to future tax years. In such a case, the home State's refusal to take account of the losses would be disproportionate to the objective of safeguarding the balanced allocation of taxing powers[1850].

Clearly, that is a matter of justification (see also 2.F.III). Justifying a discriminatory measure implies making a policy choice, that is to say, weighing conflicting interests against each other. More specifically, the taxpayer's interest of not being discriminated against is weighed against the public interest invoked by the Member State. That exercise of weighing the different interests is, to a considerable extent, subjective since it means that every interest at play should be ascribed a certain value. In the Court's case law, the weighing of the different interests is crystallized in the proportionality-test: the Court verifies whether the interest which the Member State concerned has in seeking to attain a certain objective outweights the interest which the taxpayer has in not being discriminated. In the present case, the policy question to be resolved is **which Member State is responsible** for taking the losses into account. The conflicting interests are, on the one hand, the taxpayer's desire to have all of his losses taken into account in a similar manner to taxpayers who exercise all their activities in their home State and, on the other hand, the interest of the home State to ensure that the balanced allocation of taxing powers is not upset[1851].

[1849] E.g. C446/03, *Marks &* Spencer, 13 December 2005, § 45-46; C-414/06, *Lidl*, 15 May 2008, § 31-32.
[1850] E.g. C446/03, *Marks &* Spencer, 13 December 2005, § 55; C-414/06, *Lidl*, 15 May 2008, § 47.
[1851] Generally, the balance tips in favour of the home State's interest, meaning that the home State's refusal to take account of the foreign losses is justified. Exceptionally, however, the Court attaches more weight to the taxpayer's interest, in which case the measure becomes disproportionate to the aim sought by the home State. As

So the question as to who is 'to blame' for the disadvantage is an aspect of the justification-test. Does that mean that the question as to whether the disadvantage is 'due to' the legislation of the Member State concerned is also affected by the justification-analysis, even though that question is an aspect of the disadvantage-test? In my opinion, that is not the case since determining whether the disadvantage is 'due to' the Member State whose tax system is under scrutiny is different from assigning blame to a Member State. The former issue requires an objective assessment: deciding whether a disadvantage is due to a given measure only requires one to verify whether there is a causal link between that disadvantage and the measure in question. If that is the case, the disadvantage-test is complete, with the result that there is discrimination which is, in principle, contrary to the Treaty freedoms. In the next step, it should be determined whether that discrimination is justified. The question thus arises whether the Member State which is found to discriminate is **responsible** for granting the benefit in question (e.g. loss relief). If it is not, that State cannot be blamed for denying the advantage (i.e. for discriminating). In such a situation, the discrimination is justified. So deciding which Member State is 'to blame' for the disadvantage comes down to designating the Member State which is responsible for granting a certain tax benefit (but has not done so). That is a subjective appraisal. As noted above, that appraisal requires making a policy choice in that the taxpayer's interest should be weighed against the Member States' interest.

I have argued repeatedly that the comparability-test and the disadvantage-test are objective in nature and should therefore remain unaffected by elements of the justification-test, which are inherently subjective. That is also the case here. Deciding whether a disadvantage is 'due to' the legislation under scrutiny is an entirely objective determination, which should be distinguished from the (subjective) issue which State is responsible for granting the benefit in question (and, thus, which State is 'to blame' for the disadvantage if the benefit is not granted). But after it has been established that the disadvantage is due to the legislation of the Member State in question, it should be verified whether that Member State was responsible for granting the benefit to begin with. If that is not the case, the discrimination is justified.

2. The position of the test in the Court's case law

Despite its importance in the discrimination-analysis, the disadvantage-test is somewhat overlooked in the Court's case law and it is only rarely addressed in a systematic manner. As an analysis of the relevant case law will reveal, the aspect of the disadvantage-test which gets the most attention from the Court concerns the relevance of offsetting advantages. From a theoretical point of view, it could be argued that a disadvantage incurred by the taxpayer is removed if he enjoys a counterbalancing advantage at the same time. In general, however, the ECJ is very reluctant to take account of such offsetting advantages, irrespective of whether those advantages are granted in the discriminating Member State or elsewhere.

It is remarkable that the existence of such offsetting advantages (and their relevance) usually comes up for discussion as an element in the Court's justification-analysis. Most likely, that is because Member States argue that the discrimination caused by their tax laws is 'justified' by the existence of other, offsetting advantages. The Court has also adopted this language and

pointed out above, that is the case where the taxpayer has exhausted all possibilities to have the losses taken into account in the source State.

often refers to these issues as matters of justification[1852]. As mentioned earlier, the ECJ is not always very accurate in its language when referring to 'justifications'. I have already noted before that the Court sometimes holds that the incomparability of two situations 'justifies' a difference in treatment. However, it is clear that no justification is necessary if the situations are incomparable. Discrimination can only arise if comparable situations are treated differently (or, vice-versa, if different situations are treated identically). Consequently, if the situations cannot be compared, there is no discrimination, which means that there is nothing to justify. Similarly, it is misleading to use the verb 'justify' when discussing offsetting advantages, as the analysis is still in the disadvantage-phase. As the existence of discrimination is yet to be determined, there is nothing to justify. Only in the event where the first two steps are taken (i.e. comparability and disadvantage), is there discrimination which may be susceptible to justification.

b. In general: what is a disadvantage?

As discussed earlier, the Court's general position as regards the interpretation of the Treaty freedoms is based on the concept of non-discrimination, rather than that of equal treatment. As a result, it is not sufficient to merely demonstrate that the subject of comparison and the object of comparison are treated differently: it is necessary to establish that the subject of comparison incurs a disadvantage as compared to the object of comparison[1853].

With respect to the extent of such a disadvantage, the Court has consistently held in its direct tax case law that any disadvantage, however small, is sufficient to constitute a breach of the Treaty freedoms[1854]. This idea was already articulated in *Avoir fiscal*, when the French

---

[1852] E.g. *Verkooijen*, § 61: *"As regards, finally, the argument based on a possible tax advantage for taxpayers receiving in the Netherlands dividends from companies with their seat in another Member State, it is clear from settled case-law that unfavourable tax treatment contrary to a fundamental freedom* ***cannot be justified*** *by the existence of other tax advantages, even supposing that such advantages exist"* (emphasis added).

[1853] That might seem obvious, but it is nevertheless important when trying to convince the Court that a national measure is incompatible with the Treaty freedoms. See e.g. C-105/08, *Commission v Portugal*: under Portuguese tax law, interest paid by a resident to a non-resident bank was subject to a definitive source tax of 20%, levied on the gross amount of the income. In the majority of cases, the rate of 20% was reduced to 10% or 15% under a tax treaty. Interest paid to a resident bank was included in the recipient's taxable profits and subject to a tax rate of 25%, levied on the net amount of the income. The Commission argued that this distinction constituted discrimination contrary to the free movement provisions. The Court dismissed that position because the Commission did not demonstrate that non-residents banks were treated less favourably (even though it was clear that there was a difference in treatment): *"in order to prove that the Portuguese legislation,* ***which, it is not disputed, treats resident and non-resident legal entities differently*** *with regard to IRC, results in higher taxation of non-resident legal entities, the Commission relies on an arithmetical example based on the assumption that the profit margin achieved by the entity in question in that example is 10%. It is, however, clear that, in the present case,* ***the Commission failed to produce*** *[…]* ***any conclusive evidence*** *whatever which would have been capable of establishing that the figures which it puts forward in support of its argument* ***are in fact borne out by the actual facts*** *and that the arithmetical example on which it relies is not purely hypothetical"* (C-105/08, *Commission v Portugal*, 17 June 2010, § 27-30, emphasis added). Since the Commission did not demonstrate that the differential treatment effectively resulted in less favourable treatment of the subject of comparison, the Commission's action was dismissed. See also the Opinion of Advocate-General Kokott in C-105/08, *Commission v Portugal*, 25 March 2010, § 36-48, in particular § 40: *"throughout the proceedings, [the Commission] relied solely on hypothetical calculations presented as examples. Although the Commission does not have to show that the taxation of non-residents is heavier than that of residents in every individual case, it must nevertheless demonstrate that failure to fulfil obligations is possible from a factual point of view"*.

[1854] This is in line with the Court's interpretation of the freedoms in its non-tax case law; see e.g. C-49/89, *Corsica Ferries France*, § 8: *"As the Court has decided on various occasions, the articles of the EEC Treaty concerning the free movement of goods, persons, services and capital are fundamental Community provisions and any restriction, even minor, of that freedom is prohibited"*. See also e.g. C-169/98, *Commission v France*, §

government argued that the disadvantages resulting from the national measure at issue were *"in any event insignificant"*[1855]. The ECJ held that *"it is […] not necessary in this context to assess the extent of the disadvantages which branches and agencies of foreign insurance companies suffer as a result of the failure to grant them the benefit of shareholders' tax credits and to consider whether those disadvantages could have any effect on their tariffs, since Article [43] prohibits all discrimination, even if only of a limited nature"*[1856].

Moreover, the French government had further stressed the insignificance of the disadvantage by pointing out that it *"may be easily avoided by setting up a subsidiary in France"*[1857]. The Court dismissed this argument as well, by referring to the second sentence of Article 43 (1), which *"expressly leaves traders free to choose the appropriate legal form in which to pursue their activities in another Member State and that freedom of choice must not be limited by discriminatory tax provisions"*[1858].

This is a clear example of the Court's refusal to introduce a 'de minimis'-exception in the disadvantage-test. As soon as the subject of comparison is treated less favourably, the requirement has been violated, regardless of the severity of the disadvantage: it is settled case law that any disadvantage, even minor, can violate the disadvantage-test[1859]. For instance, the Court has repeatedly held that (even minor) cash flow disadvantages may constitute a disadvantage[1860].

Moreover, the Court has repeatedly held that it is not necessary that the disadvantage has **actually** occurred: legislation may violate the treaty freedoms as soon as it **is capable** of treating the protected category less favourably (i.e. a potential disadvantage is sufficient, rather than an actual disadvantage). For instance, in *Thin Cap GLO*, the Court decided as follows: *"in order for such legislation to be considered to be a restriction on freedom of establishment, it is sufficient that it be capable of restricting the exercise of that freedom in a Member State by companies established in another Member State, and it is not necessary to establish that the legislation in question has actually had the effect of leading some of those companies to refrain from acquiring, creating or maintaining a subsidiary in the first Member*

46 and C-212/06, *Government of the French Community and Walloon Government v Flemish Government*, § 52. In this respect, reference should also be made to Joined cases 3-58 to 18-58, *Erzbergbau*, 10 May 1960, § 3: *"The concept of discrimination does not imply, by definition, the fact that direct damage is caused. The meaning of this concept is primarily that unequal conditions are laid down for comparable cases. The application of such unequal conditions may, it is true, bring about damage, which can then be considered as the consequence by which that discrimination may be detected. However it would be arbitrary to reduce the concept of discrimination solely to those cases of unequal treatment in which the interested parties in fact suffer damage."*

[1855] C-270/83, *Avoir fiscal*, § 17.

[1856] C-270/83, *Avoir fiscal*, § 21.

[1857] C-270/83, *Avoir fiscal*, § 17.

[1858] C-270/83, *Avoir fiscal*, § 22. The argument that the disadvantage 'can easily be avoided' has been raised a number of times since *Avoir fiscal*. In *Bachmann*, for instance, the Belgian government argued that a national of another Member State wishing to accept a job in Belgium *"can easily bring his contract to an end and conclude a new contract with a mutual insurance company recognized by Belgium, with a view to gaining the benefit of the deductibility."* The Court dismissed this argument, pointing out that the obligation to terminate the contract with the first insurer would in itself constitute a disadvantage, by reason of the arrangements and expense involved (C-204/90, *Bachmann*, § 12-13).

[1859] See also e.g. Opinion of Advocate-General Alber in C-141/99, *AMID*, § 29 and Opinion of Advocate-General La Pergola in C-35/98, *Verkooijen*, § 39.

[1860] E.g. joined Cases C-397/98 and C-410/98, *Metallgesellschaft*, § 44, 54 and 76; C-436/00, *X and Y*, § 36-38; C-446/03, *Marks & Spencer*, § 32-34; C-446/04, *Test Claimants in the FII Group Litigation*, § 96-97 and § 153-154; C-347/04, *Rewe*, § 29-30.

State"[1861]. Similarly, the argument that the discriminatory measure at issue may sometimes function to the advantage of the subject of comparison is consistently dismissed by the Court[1862]. Finally, the fact that a domestic regime is **optional** does not mean that it is not incompatible with the fundamental freedoms[1863].

All in all, this is quite a liberal test, intended to ensure a the broadest possible protection of market participants. Any disadvantage, actual or potential, and regardless of its size, is sufficient to constitute discrimination, provided that the other conditions are met.

1. FII: the disadvantage is inherent in a system that is compatible with the Treaty freedoms

However, it should be stressed at this point that some disadvantages escape the disadvantage-test, not because they are insignificant, but because they are an intrinsic part of a system that is compatible with the Treaty freedoms.

A good example of this nuance can be found in *FII.* As mentioned in 2.E.I.A.b.6.b.7, the Court decided in that case that, in principle, it is not contrary to the Treaty freedoms for a Member State to prevent economic double taxation on domestic dividends by applying an exemption system and on foreign-sourced dividends by applying a credit system. The ECJ does not have the authority to choose between credit and exemption as the most appropriate method to avoid double taxation. That is a matter of nationality sovereignty, so it is up to the Member States to make this choice. In that respect, the ECJ refers to Article 4 of the Parent-Subsidiary Directive, which expressly leaves Member States free to opt for either credit or exemption[1864]. For the ECJ, therefore, the choice between credit and exemption is entirely neutral: both methods are, in principle, compatible with the fundamental freedoms, since neither discriminates on any prohibited basis. And, since neither is preferable over the other, it is not problematic if a Member State applies one system to domestic dividends and another system to foreign-sourced dividends. However, this distinction must not lead to discrimination. That is to say, the cross-border situation must not incur a disadvantage as compared to the domestic situation. Yet, the application of a credit system brings about administrative burdens for resident taxpayers receiving foreign-sourced dividends, particularly with regard to demonstrating the amount of tax actually paid in the distributing company's State of establishment. Even though the Court has consistently held that administrative compliance burdens constitute obstacles to the free movement provisions[1865], the Court decides in *FII* that such burdens are not contrary to the fundamental freedoms because they are *"an intrinsic part of the operation of a tax credit system"*[1866].

[1861] C-524/04, *Thin Cap GLO*, § 62. The same argument was repeated in C-231/05, *Oy AA*, § 42 and C-311/08, *SGI*, § 50.

[1862] E.g. C-562/07, *Commission v Spain*, 6 October 2009: *"Admittedly, because of the application to them of the progressive scale, residents were* ***not systematically*** *entitled to a more favourable taxation rate than non-residents in relation to the taxation of capital gains realised upon the sale of assets owned for one year or less. Nevertheless, given that non-residents were subject to a flat rate of 35% irrespective of the amount of the capital gain realised, whereas residents were subject to that rate only when their overall income reached a certain threshold, non-residents were subject,* ***at least in some circumstances****, to a tax liability greater than that borne by residents"* (emphasis added). See also 2.E.I.B.c, on the relevance of offsetting advantages.

[1863] E.g. C-446/04, *FII*, § 161-162.

[1864] C-446/04, *FII*, § 44.

[1865] See e.g. C-470/04, N, § 38; C-290/04, *Scorpio*, § 47.

[1866] C- 446/04, *FII*, § 53.

> That is a questionable position. Applying a credit system may give rise to considerable administrative difficulties for the taxpayer, given the necessity to trace back the original profit from which the dividend is ultimately paid out, and the fact that it may concern profits made by third or fourth-tier subsidiaries (depending on the degree to which the parent company's State of residence allows the foreign tax to be credited). It is therefore stunning that the U.K. itself acknowledges in *FII* that the indirect credit system at issue requires "*lengthy and complex checks [to be] carried out*", which would justify refusing it if the shareholding does not exceed 10% (see 2.E.I.B.a.6.b.7)[1867].
>
> It is not clear to me why the fact that the administrative difficulties are 'inherent' in the credit system would mean that they cannot give rise to discrimination. The Court's reasoning is circular since it first considers the choice between credit and exemption to be compatible with the fundamental freedoms on the basis of the assumption that the choice is neutral for the taxpayer, and then it states that the greater administrative burdens imposed by one system do not give rise to discrimination because they are inherent in a system which, in itself, is not discriminatory. But if one of the systems causes greater administrative burdens, the choice between the systems was not neutral to begin with[1868].
>
> It is entirely correct that the ECJ is not entitled to choose between credit and exemption. As noted above, that is a matter of national sovereignty, to be decided by the Member States. Additionally, the methods, in themselves, do not discriminate since they do not introduce any distinction. As a result, both the credit system and the exemption system, in themselves, are compatible with the fundamental freedoms. But it would be incorrect to infer therefrom that the choice between both systems is neutral for the taxpayer: it is clear that the credit system entails additional administrative burdens as compared to the exemption system. So where the credit system is applied, the taxpayer is faced with additional administrative burdens. Yet, that does not mean that the exemption system should be preferred. As long as there is no discrimination, there is no incompatibility with the fundamental freedoms. In other words, as long as both domestic and inbound dividends are subject to the same system, there is no discrimination (even if that systems causes administrative difficulties for both categories[1869]). Consequently, if the Court's remarkable position in *FII* was guided by a reluctance to choose between credit and exemption, then that reluctance was misguided: removing the discrimination in *FII* did not require the ECJ to make a choice between the two methods. It would be sufficient to require the same system – either credit or exemption – to be applied both to domestic and to inbound dividends[1870]. But Member States would still be free to choose the applicable system, as long as they do so in a non-discriminatory way.

From this, it could be inferred that where a system as such is compatible with the Treaty freedoms, the inherent difficulties (e.g. of an administrative nature) connected with the application of that system are not considered to violate the disadvantage-test. Apart from the conceptual objections against that position (see supra), it may be difficult to determine whether a disadvantage is 'an intrinsic part' of a tax system.

[1867] C-446/04, *FII*, § 66.

[1868] See also O. MARRES, "Case note under C-446/04, Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue", *Sociaal-Economische Wetgeving* 2007, 301.

[1869] As a side-note, it should be observed that credit systems may also create other disadvantages as compared to exemption systems, for instance where the credit is limited to the tax paid by first-tier subsidiaries (i.e. outside of the scope of the Parent-Subsidiary Directive, since Art. 4 of the Directive would preclude such a limitation).

[1870] See also P. WATTEL, "Case note under C-446/04, Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue", *BNB* 2007/130.

2. Columbus Container Services: an application of the *FII*-nuance

As mentioned in 2.E.I.A.b.9.e.2, the Advocate-General decided in *Columbus* that no vertical discrimination arose because Columbus' partners did not encounter a disadvantage as compared to a comparable domestic situation. In order to reach this conclusion, the A.-G. first observed that the German switch-over had unquestionably led to a significant increase in their taxation in the tax year in question as compared with the preceding tax year. However, he immediately adds that this unfavourable treatment in itself does not violate the Treaty freedoms: "*Community law does not guarantee, in a sphere in which the Member States remain competent, application and retention over time of identical treatment for the same taxpayer. If that were the case, Member States would no longer be able to alter the basis or rate of their direct taxes, for example. This is impossible in the current state of development of Community law. […] A difference in treatment under Community law is not measured in the light of a factual or legal change in the situation of one and the same person. It requires rather a comparison between the situation of persons who have exercised one of the freedoms granted by the Treaty and that of persons who have not done so.*" According to the Advocate-General, there was no such difference in treatment in the *Columbus*-case. On the contrary, the German switch-over amounted to treating Columbus' partners in the same way as German taxpayers who were partners in fiscally transparent partnerships located in Germany and who had not exercised their right of freedom of establishment in another Member State[1871].

The Advocate-General then applies the *Gilly*-reasoning, from which he infers that Member States retain not only the opportunity not to avoid double taxation, but also the choice of the mechanism for avoiding double taxation. Consequently, Member States are allowed in particular to opt either for the exemption method or for the credit method. However, regardless of which procedure is adopted in order to avoid double taxation, Member States must comply with the fundamental freedoms, since they cannot exercise their powers of taxation in such a way that they treat comparable situations differently. In the *Columbus Container*-case, the profits made by Columbus were directly allocated to the partners and were regarded as their income, in exactly the same manner as would have happened in the case of a German partnership. Moreover, they were taxed during the same tax year and at the same rate in Germany as the German partners in a German partnership. Accordingly, the switch-over from exemption to credit method guaranteed equal treatment as regards taxation of foreign income and German income, i.e. the switch-over ensured equal treatment with a comparable domestic situation. Unlike the exemption method, however, the credit method involved additional administrative charges for Columbus' partners, but the Advocate-General considered those charges to be inherent in the application of the credit method[1872].

This latter issue is an application of the *FII*-nuance to the disadvantage-test as set out above. Member States are free to choose between the credit method and the exemption method, provided that they do so in a non-discriminatory manner. The fact that the credit method brings about certain additional administrative burdens does not give rise to a violation of the disadvantage-test, since these burdens are inherent in the credit system itself. Consequently, a taxpayer cannot criticize a Member State's choice for the credit system on the sole basis that this choice results in additional administrative burdens as compared to the exemption system. In his Opinion in *Columbus Container*, the Advocate-General makes a logical application of

[1871] § 73-79 of the Opinion.
[1872] § 89-97 of the Opinion, referring to C-446/04, *FII*.

that principle: since the choice between both systems cannot be criticized on that basis, neither can the switch-over between those systems from one year to another.

The Court took note of these arguments. It started its analysis by pointing out that even if the credit method rendered Columbus' activities more expensive for the partners than if the taxation had been carried out using the exemption method, that does not necessarily mean that the German measure violated the freedom of establishment. As the German tax legislation did not make any distinction between taxation of income derived from the profits of partnerships established in Germany and taxation of income derived from the profits of partnerships established in a low-tax Member State, partnerships such as Columbus did not suffer any tax disadvantage in comparison with partnerships established in Germany. By applying the credit method to such foreign partnerships, that legislation merely subjected the profits made by such partnerships to the same tax rate in Germany as profits made by partnerships established in Germany. As a result, there was no discrimination between those two categories of partnerships[1873].

Given the absence of a difference in treatment, it was necessary for the Court to consider whether the situations were incomparable, in which case the identical treatment would be discriminatory. In this context, the Court refers to *Kerckhaert-Morres* and observes that *"in respect of the tax legislation of his State of residence, the position of a partner receiving profits is not necessarily altered merely by the fact that he receives those dividends from a company or partnership established in another Member State, which, in exercising its fiscal sovereignty, makes those profits subject to taxation amounting to less than 30% of the profit actually made"*[1874].

After confirming this comparability, the Court holds that *"in circumstances such as those in the main proceedings, the adverse consequences which might arise from the application of a system for the taxation of profits such as that put in place by the AStG result from the exercise in parallel by two Member States of their fiscal sovereignty"*[1875]. This might seem remarkable. Since the Court had already decided that there was no discrimination, one would expect that there was no need to examine the cause of any 'adverse conseqeuences' of the German measure. As explained by the Advocate-General, the only disadvantage to speak of was the increase in the partners' taxation in the tax year in question as compared with the preceding tax year (due to the introduction of the switch-over). However, that is not a relevant comparison and the Treaty freedoms do not offer any protection in respect of such disadvantages. The only relevant comparison to be made in the vertical context was the comparison to a comparable domestic situation. As confirmed by the Court, no disadvantage arose in that context. Therefore, it might seem unnecessary to add that the adverse consequences are caused by the parallel exercise of fiscal sovereignty.

However, this additional observation seems to be an application of the line of reasoning that first appeared in *Kerckhaert-Morres*. As the measure applied identically to domestic and cross-border situations, the first question to be answered was whether this identical treatment was nevertheless discriminatory, on the basis that the situations were incomparable. As discussed, no discrimination arose, because the situations were not incomparable. After that discrimination-analysis, however, the Court goes on to verify whether the non-discriminatory measure was restrictive, as it did in *Kerckhaert-Morres* (see 2.D.V.C and 2.E.I.A.b.6.b.5). In

[1873] C-298/05, *Columbus Container*, § 38-40.
[1874] C-298/05, *Columbus Container*, § 42 (see also 2.E.I.A.b.6.b.5).
[1875] C-298/05, *Columbus Container*, § 43.

line with its earlier case law, the Court decides in this respect that neutral measures of substantive direct tax law do not give rise to prohibited restrictions: the disadvantages resulting from such measures are due to disparities, and therefore outside the scope of the Treaty freedoms.

> A fundamental issue in international taxation is the choice of a method to ensure neutrality in the taxation of cross-border income. It is commonly understood that the two classical methods, capital import neutrality (CIN) and capital export neutrality (CEN), cannot be achieved at the same time in the absence of identical tax rates and tax bases in source and residence countries[1876]. CEN seeks to achieve locational neutrality, in that it tries to ensure neutrality between taxpayers investing in their State of residence or abroad. In other words, the combined source State tax and residence State tax on the outbound activity must be the same as the residence State tax on the domestic activity. Consequently, if the outbound activity is taxed in the source State, CEN requires that the residence State grants a full credit (and a refund) of source State tax. CIN, on the other hand, promotes competitive neutrality, in that it tries to ensure equal taxation of resident and non-resident investors in a given State. For the source State, this implies taxing residents and non-resident investors in the same way. For the residence State, this implies exempting foreign-source income in order to ensure that foreign income is only subject to source State tax. It has been argued that a number of inconsistencies in the ECJ's case law are due to its efforts to achieve CEN and CIN at the same time[1877]. Applied, for instance, to dividend cases, the ECJ simultaneously promotes CEN by requiring the residence State to extend credits to inbound dividends and CIN by requiring the source State to extend credits to outbound dividends. But since CEN and CIN cannot be achieved simultaneously (absent harmonization), the ECJ's case law is ultimately incoherent.
>
> It should be recalled, however, that the ECJ does not have the authority to choose between CEN and CIN. That is a matter of sovereignty, left to the Member States to decide. Choosing between both approaches is a policy choice which is not, in principle, affected by the fundamental freedoms. In my opinion, therefore, the apparent incoherence in the ECJ's case law is not due to the fact that the Court sometimes applies CEN and sometimes CIN, but simply because it is not allowed to prefer one over the other. As a result, some of its decisions are in conformity with CEN and some with CIN, but that is simply the by-product of the application of the non-discrimination test.
>
> This issue is illustrated by the ECJ's decision in *Columbus*. Since the German measure at issue sought to achieve locational neutrality (i.e. the switch-over was intended to ensure equal tax treatment between the domestic activities of resident taxpayers and the foreign activities of resident taxpayers), the ECJ's judgment could be read as supporting CEN. However, that does not mean that the ECJ interprets the non-discrimination standard on the basis of CEN. The logical[1878] application of the non-discrimination standard coincidentally resulted in a decision in this case which is compatible with CEN. Another case which is sometimes referred to as an example of the Court promoting CEN is *Marks & Spencer* (see 2.E.I.A.b.4.d), in that the Court required the residence State to grant the same treatment to domestic investments and cross-border investments: in both cases, losses suffered by the subsidiary must grant entitlement to relief (somewhere). Once

[1876] R. MASON, "Tax discrimination and capital neutrality", *World Tax Journal* 2010, 131-132.
[1877] M. Graetz and A. Warren, "Income tax discrimination and the political and economic integration of Europe", *Yale Law Journal* 2006, 1186-1255.
[1878] Logical, in that it is entirely in line with *FII* as regards the disadvantage-test. As noted above, however, the idea that the additional administrative difficulties imposed by the credit system do not give rise to discrimination because they are 'inherent' in that system is open to criticism. Moreover, and as noted earlier, the Court's position on horizontal discrimination in *Columbus* is also open to criticism. However, that has nothing to do with CEN, but with the ECJ's reluctance to acknowledge an MFN-component in the fundamental freedoms.

again, however, I see no reason to assume that the Court is willingly promoting CEN over CIN. Rather, the application of the non-discrimination standard resulted in a decision that, coincidentally, squares with CEN. Since resident companies with non-resident subsidiaries were comparable to resident companies with resident subsidiaries, the disadvantage incurred by the former constituted discrimination in the absence of valid justification grounds. The mere fact that this resulted in a situation where an impediment to locational neutrality is removed, does not mean that the Court seeks to promote CEN.

To sum up, non-discrimination and neutrality are both fundamental concepts that determine the way cross-border income is taxed. Both concepts have a number of manifestations. For instance, the principle of non-discrimination can take the shape of a prohibition of discrimination against non-nationals, or a prohibition of discrimination against foreign-owned entities, etc. Similarly, the principle of neutrality can take the shape of CEN, CIN, national neutrality, etc[1879]. But it is essential that both concepts are, in principle, independent, without one having preference over the other. Of course, there is a certain degree of influence between them. In particular, achieving a certain type of neutrality requires that certain types discrimination are prohibited[1880]. Consider, for instance, Art. 24 OECD MC. That provision does not promote CEN, since it does not require the residence State to ensure equal treatment of residents investing domestically and residents investing abroad. To some extent, Art. 24 does promote CIN, since it requires the source State to treat foreign and domestic investors identically in a number of situations. However, it does not go far enough to achieve CIN, since it does not require the source State to grant equal treatment to residents and non-residents in all situations[1881]. The same is true for the non-discrimination principle embodied in the fundamental freedoms. In a number of situations, the result achieved by applying those freedoms will be in conformity with CEN or CIN, but that does not mean that the ECJ seeks to promote either type of neutrality. Ultimately, choosing the type of neutrality to be implemented is a matter for the Member States. The ECJ can only determine whether that choice has been implemented in a non-discriminatory manner. And in *Columbus*, the ECJ held that the German system, which happened to promote CEN, did not give rise to discrimination.

c. The relevance of offsetting advantages in the State the tax system of which is under scrutiny

1. Avoir fiscal

The *Avoir fiscal*-judgment, which was discussed in 2.E.I.A.a.1.a, was not only a milestone in respect of the comparability issue. The case was also highly influential as regards the disadvantage-test. Apart from the incomparability-defense, discussed earlier, the French government advanced two arguments concerning (the existence and severity of) disadvantages in order to establish that no discrimination had occurred. The first argument concerned the limited extent of the disadvantage. As discussed above, the ECJ dismissed this argument in clear terms, thereby refusing to introduce a de minimis-test in the disadvantage-analysis.

[1879] F. SHAHEEN, "International tax neutrality: revisited", *Tax Law Review* 2011, 131-147 lists five neutrality theories: CEN, CIN, national neutrality, capital ownership neutrality and national ownership neutrality.

[1880] The opposite is not necessarily true. Choosing a type of non-discrimination does not imply that a certain type of neutrality can no longer be achieved. For instance, prohibiting discrimination of non-residents as compared to residents (which is in conformity with CIN) does not preclude a State from pursuing CEN (i.e. by granting a full credit for source State tax).

[1881] See R. MASON, "Tax discrimination and capital neutrality", *World Tax Journal* 2010, 133.

Secondly, the French government contended that PEs of non-resident companies enjoyed *"various advantages over French companies which balance out any disadvantages in regard to shareholders' tax credits"*[1882]. The Court dismissed this argument, thereby setting out a clear line in respect of such offsetting advantages. According to the Court, *"the difference in treatment […] cannot be justified*[1883] *by any advantages which branches and agencies may enjoy vis-à-vis companies and which, according to the French government, balance out the disadvantages resulting from the failure to grant the benefit of shareholders' tax credits. Even if such advantages actually exist, they cannot justify a breach of the obligation laid down in Article [43] to accord foreign companies the same treatment in regard to shareholders' tax credits as is accorded to French companies"*[1884].

Thus, the Court is quite clear: offsetting advantages cannot remove the disadvantage. In other words, the measure under scrutiny should be examined in isolation, without interference from other measures, which might counterbalance the disadvantage. Even if counterbalancing advantages place the subject of comparison in an identical (or even better) tax position than the object of comparison, the rule at issue will still be discriminatory[1885].

The French government had also brought forward a very similar argument, which was discussed in the Advocate-General's opinion: instead of referring to offsetting advantages which could offset the disadvantage, the French government argued that the French rule (i.e. the absence of a tax credit for non-residents) was the counterpart of the absence of a corresponding concession for PEs of **French** companies established in other Member States. In other words, France defended the disadvantage incurred by the subject of comparison (non-residents having a PE in France) by arguing that it counterbalanced similar disadvantages incurred by the object of comparison (residents having a PE in another Member State[1886]). I will refer to this idea as the concept of 'counterbalancing disadvantages'[1887].

[1882] C-270/83, Avoir fiscal, § 17. Particularly, permanent establishments enjoyed a tax advantage in that they avoided the burden of certain taxes to which legal persons were subject (taxes payable upon constitution, transformation, merger, division or dissolution). Cf. Opinion of Advocate-General Mancini in *Avoir fiscal*, 16 October 1985, *ECR* 1986, 273, § 3 and 9.

[1883] As mentioned earlier, the ECJ sometimes refers to arguments under the disadvantage-test as matters of 'justification'. In the present case, the argument of the French government was that, overall, no disadvantage arose for PEs because possible disadvantages were balanced out by advantages. The Court dismissed this argument by holding that the measure at issue had to be considered in isolation, without interference from possible counterbalancing measures. As a result, it is not entirely correct to refer to the French government's argument as a matter of 'justification', since it concerns the existence of discrimination itself. Indeed, accepting the French government's argument would mean that no disadvantage had occurred, which would imply that there was no discrimination (and, therefore, nothing to justify).

[1884] C-270/83, Avoir fiscal, § 21.

[1885] See also C-233/09, *Dijkman*, § 39-43: the Belgian government argued that the disadvantage at issue (i.e. the additional municipal tax on foreign income from movable property) was compensated for by the fact that such foreign income was taxed by way of assessment while domestic income from movable property was immediately tax by way of a withholding at source. According to the Belgian government, this cash-flow advantage counterbalanced the disadvantage consisting of the additional tax. Unsurprisingly, the ECJ dismissed this argument: *"the imposition, by a Member State, of a supplementary tax on income from moveable assets from investments made in another Member State, as opposed to income from investments made in the first Member State, constitutes in itself unfavourable tax treatment which is inconsistent with the free movement of capital. In accordance with the case-law, unfavourable tax treatment contrary to a fundamental freedom cannot be considered to be compatible with European Union law as a result of the existence of other advantages, even supposing that such advantages exist […]. Moreover, a restriction on a fundamental freedom is prohibited by the Treaty, even if it is of limited scope or minor importance"*.

[1886] As noted in the general discussion of *Avoir fiscal*, the object of comparison was actually a resident company, rather than a resident company having a PE in another Member State. Thus, in order to take account of

Referring to earlier case law[1888], the Advocate-General dismissed this concept and held that *"in assessing an infringment of Community law, extraneous factors such as, in the case of a discriminatory act, the likelihood that it will counterbalance discrimination elsewhere, must be left out of consideration"*[1889].

Interestingly, a similar consideration was also mentioned by the French Minister of Finance when presenting the bill implementing the tax credit: *"We wanted this concession […] to be reserved either to the French themselves or to persons resident in France. We obviously do no exclude the possibility of extending the concession by way of suitable agreements which may be negotiated to nationals of other countries which adopt an approach corresponding to our own. […] Before extending the concessions […] to nationals of other countries, we must therefore ensure that French residents of those countries are able to benefit from the same advantages on a reciprocal basis"*[1890]. Thus, in the opinion of the French government, the tax credit should only be granted in cases where French nationals, residing in the other State, would be able to benefit *"from the same advantages on a reciprocal basis"*. The logical counterpart of the absence of such reciprocal advantages would then be the refusal of the credit in France.

According to the Advocate-General, however, that argument did not hold, as the position that *"the credit should be applied to companies incorporated in other Member States only in so far as those States grant the same concession to French companies"* was *"without foundation in the Community context."* In other words, it is impossible to argue that a disadvantage, consisting of the refusal of an advantage, is counterbalanced by the other State's refusal to grant a similar advantage in the opposite situation.

On a related note, the French government had argued that, in order to resolve the problem at issue, it was sufficient to add additional provisions to the existing tax treaties between France and other Member States. In those provisions, the *avoir fiscal* would have to be extended on the basis of reciprocity. As this argument relates to the influence of tax treaties on the disadvantage-test, it will be discussed in 2.E.I.B.e.1.

2. Commerzbank

In *Commerzbank*, The U.K. government brought forward an argument similar to the French government's argument in *Avoir fiscal*[1891]. In particular, the U.K. government argued that *"far from suffering discrimination under the United Kingdom tax rules, non-resident companies which are in Commerzbank's situation enjoy privileged treatment. They are*

---

counterbalancing disadvantages in other Member States, the French government was required to use a different object of comparison, which explains why the argument failed.

[1887] This term is merely used for reasons of conceptual clarity. Of course, a 'counterbalancing disadvantage' is, in effect, also a 'counterbalancing advantage'. More specifically, the fact that the object of comparison encounters a disadvantage means that the subject of comparison enjoys an advantage (i.e. the absence of the disadvantage). It is this advantage which explains why the measure at issue works to the detriment of the subject of comparison. In order to avoid lengthy explanations on how a disadvantage is explained by the absence of another disadvantage, I will refer to this idea as the concept of counterbalancing disadvantages.

[1888] Joined Cases 62 and 63/81, *Seco v EVI*, 3 February 1982, *ECR* 1982, 223.

[1889] Opinion of Advocate-General Mancini, 16 October 1985, *ECR* 1986, 273, § 7.

[1890] Opinion of Advocate-General Mancini, 16 October 1985, *ECR* 1986, 273, § 10.

[1891] See supra, on § 17 and 21 of *Avoir fiscal*. See also the discussion of the application of Art. 24(3) in *Commerzbank* in Part II, 2.D.III.C.a.2.

exempt from tax normally payable by resident companies"[1892]. The offsetting advantage put forward by the U.K. government consists of the fact that non-resident companies are exempt from tax normally payable by resident companies. The total absence of taxation would then counterbalance the (minor) disadvantage consisting of the refusal of repayment supplement on overpaid tax.

The ECJ dismissed this argument by observing that the national provision at issue *"entails unequal treatment. Where a non-resident company is deprived of the right to repayment supplement on overpaid tax to which resident companies are always entitled, it is placed at a disadvantage by comparison with the latter. The fact that the exemption from tax which gave rise to the refund was available only to non-resident companies cannot justify a rule of a general nature withholding the benefit. That rule is therefore discriminatory"*[1893].

It is surprising that the Court does not repeat the formula of *Avoir fiscal*, that *"even if such advantages actually exist, they cannot justify a breach of the obligation […] to accord foreign companies the same treatment as is accorded to domestic companies."* That formula is a clear dismissal of the position that offsetting disadvantages can affect the existence of discrimination. The use of different wording in *Commerzbank* might cast some doubt on this clear dismissal.

More specifically, one could argue that the Court has implicitly abandoned its original *Avoir fiscal*-position in *Commerzbank*, and recognizes, *in abstracto*, that certain offsetting advantages could possibly remove the disadvantage. By juxtaposing the sentence *"where a non-resident company is deprived of the right to repayment supplement on overpaid tax to which resident companies are always entitled, it is placed at a disadvantage by comparison with the latter"* with *"the fact that the exemption from tax which gave rise to the refund was available only to non-resident companies cannot justify a rule of a general nature withholding the benefit"*, the Court seems to weigh the disadvantage against the counterbalancing advantage, to arrive at the conclusion that the disadvantage is more severe (which implies that discrimination has occurred)[1894]. If this is indeed the case, the *Commerzbank*-judgment has opened the possibility for Member States to defend their discriminatory tax provisions by referring to other advantages which cancel out the apparent disadvantage. However, this would entail an intricate balancing test, in which a mathematical appreciation of the disadvantage has to be compared to a similar quantification of a counterbalancing advantage (or a combination of such advantages). This would be a significant departure from the Court's traditional position, that discrimination has to be assessed in isolation, without interference from extraneous factors (see supra). Moreover, such a test would likely lead to a great deal of legal uncertainty, as it is difficult to predict which advantages are sufficient to outweigh the disadvantage.

Or perhaps the Court's wording can be explained by the fact that the U.K. government's argument was quite far-fetched: it boiled down to the idea that if a resident company would have been liable to pay the tax, there would have been no refund of overpaid tax and hence no need to pay a repayment supplement. Rephrased in this way, it becomes apparent that the U.K. government's submission was actually a comparability-argument. According to this argument, the object of comparison was a resident company that was liable to the tax in

[1892] C-330/91, *Commerzbank*, § 16.
[1893] C-330/91, *Commerzbank*, § 18-19.
[1894] See also S. VAN THIEL, *Free movement of persons and income tax law: the European Court in search of principles*, Amsterdam, IBFD Publications, 2002, 556.

question (as compared to the subject of comparison, a non-resident company which was exempt from the tax). Given this fundamental difference, the U.K. government argued that the situations were not comparable, which meant that no discrimination arose[1895].

That might explain why the ECJ did not repeat its *Avoir fiscal*-formula as regards the disadvantage-test: the Court simply wanted to point out that the appropriate object of comparison was a resident company which had overpaid tax, **for whatever reason**. The rule in issue was a general one: it denied the benefit of the repayment supplement to all non-resident companies, regardless of the type of income they received. This also explains the Court's statement that *"the fact that the exemption from tax which gave rise to the refund was available only to non-resident companies cannot justify a rule of a general nature withholding the benefit."* The reference to the 'general nature' of the rule withholding the repayment supplement thus implies that the **reason** for the repayment should not be included in the comparison. What is relevant, is that there is a repayment and that non-residents are not entitled to a supplement, while residents are.

3. Saint-Gobain

As mentioned in 2.E.I.A.a.1.e, the German government in *Saint Gobain* referred to offsetting advantages enjoyed by PEs as compared to resident companies in respect of the transfer of profits to the non-resident dominant or parent company. Having no distinct legal personality, PEs cannot distribute their profits to the dominant company in the form of dividends, as independent subsidiaries do. Their profits are directly attributed to the non-resident controlling undertaking which, to the extent of those profits, is subject in Germany only to limited tax liability. In contrast to what happens when a subsidiary distributes profits to its parent company, repatriation of profits by a PE to its head office does not attract a withholding tax at source in Germany. The profits transferred by the PE to the dominant company are therefore not taken into account in the transfer to the dominant company. Nor are they taken into account in the event of subsequent distributions which might be made by the non-resident dominant company whereas, in the case of resident companies, the profits are still subject to taxation at a later stage in the event of distribution of dividends to shareholders.

The ECJ dismisses this argument, thereby confirming its *Avor fiscal*-reasoning. The Court points out that other advantages enjoyed by permanent establishments in comparison with resident companies cannot compensate for the disadvantage of not being allowed the tax concessions. Even if such advantages exist, they cannot justify a breach of the prohibition of discrimination contrary to the freedom of establishment[1896].

4. CLT-UFA

As mentioned earlier, the German government in *CLT-UFA* argued that the reduced tax rate applicable to subsidiaries (as compared to PEs) could be explained by the fact that tax charged on a subsidiary must be set off against the tax due from the beneficiary parent company, which is subject to unlimited tax in Germany, in order to avoid double taxation of those taxpayers[1897]. This argument is quite similar to the French government's argument in *Avoir*

[1895] See C-330/91, *Commerzbank*, § 16 *in fine*: *"there is no discrimination with respect to repayment supplement: resident companies and non-resident companies are treated differently because, for the purposes of corporation tax, they are in different situation."*
[1896] C-307/97, *Saint-Gobain*, § 53.
[1897] C-253/03, *CLT-UFA*, § 21.

fiscal pertaining to the concept of counterbalancing disadvantages, which was discussed in the Advocate-General's opinion. As mentioned before, the French government argued that the French rule (i.e. the absence of a tax credit for non-residents) was the counterpart of the absence of a corresponding concession for PEs of French companies established in other Member States. In other words, France defended the disadvantage incurred by the subject of comparison (non-residents having a PE in France) by arguing that it counterbalanced similar disadvantages incurred by the object of comparison (residents having a PE in another Member State). The Advocate-General dismissed this argument in clear terms, and held that *"in assessing an infringment of Community law, extraneous factors such as, in the case of a discriminatory act, the likelihood that it will counterbalance discrimination elsewhere, must be left out of consideration"*[1898].

In *CLT-UFA*, the reason given for the beneficial tax rate for subsidiaries was that these subsidiaries incurred a disadvantage as compared to PEs: the possibility of double taxation. In particular, the rate was lower because the distributed profits were also subject to tax in the hands of the parent company, which was subject to unlimited tax in Germany. In other words, the disadvantage for the subject of comparison (non-residents having a PE in Germany) was defended by arguing that it was intended to counterbalance disadvantages incurred by the object of comparison (i.e. the possibility of double taxation).

Not surprisingly, the ECJ dismissed this argument. However, the Court did not use the clear wording of the Advocate-General in *Avoir fiscal* to do so (i.e. *"in assessing an infringment of Community law, extraneous factors such as, in the case of a discriminatory act, the likelihood that it will counterbalance discrimination elsewhere, must be left out of consideration"*). Instead, the ECJ held that the reduced tax rate did not apply only to profits distributed to parent companies resident in Germany, it also applied to profit distributions by German subsidiaries to parent companies resident in other Member States, for instance Luxembourg[1899]. Specifically, as regards the situation where the profit is distributed to a Luxembourg parent, the Court found that the reduced rate applicable to the German subsidiary *"is not compensated for by applying a higher tax rate to the profits of the Luxembourg parent company."* Pursuant to the provisions of the tax treaty between Germany and Luxembourg, both the profits of a Luxembourg company made by a German PE and those made by a German subsidiary would be exonerated from Luxembourg corporation tax[1900].

So instead of dismissing the concept of counterbalancing disadvantages, the ECJ examined whether there was an actual disadvantage for the object of comparison. This is unfortunate. One might infer that the Court could have decided otherwise if there was an actual disadvantage for German subsidiaries (i.e. a higher tax rate on the profits of the Luxembourg parent company). Assuming that such a disadvantage exists, the next step would be to weigh this disadvantage against the disadvantage incurred by the subject of comparison (see also supra, 2.E.I.B.c.2, on *Commerzbank*). Apart from being highly unpractical, such an approach would give rise to considerable legal uncertainty. A theoretically sound approach requires the disadvantage to be examined without interference from counterbalancing factors, whether they be advantageous to the subject of comparison or disadvantageous to the object of comparison.

[1898] Opinion of Advocate-General Mancini, 16 October 1985, *ECR* 1986, 273, § 7.
[1899] C-253/03, *CLT-UFA*, § 26.
[1900] C-253/03, *CLT-UFA*, § 27-28.

5. Asscher

In defense of the tax regime at issue in *Asscher*, the Dutch government argued that the higher rate was intended to avoid that the tax burden on non-resident, non-contributing taxpayers would be lighter than on resident taxpayers. If the higher rate were not applied, non-resident, non-contributing taxpayers would enjoy a tax advantage over residents, for whom the abolition of the right to deduct social security contributions has entailed an increase in taxable income and in the amount of tax payable.

Before the lower tax rate for residents was introduced, a uniform rate of 14% applied to residents and non-residents. However, residents could deduct social security contributions paid in the Netherlands from their taxable base. At the same time the lower tax rate for residents was introduced, the entitlement to the deduction of social security contributions was withdrawn. In other words, the lowering of the rates could be seen as a counterbalancing measure for the withdrawal of the deductibility. As non-residents were not affected by this withdrawal, they were not entitled to the lower tax rates.

Worded in terms of a disadvantage-issue: the advantage for residents was introduced to counterbalance a disadvantage incurred by residents. As non-residents did not incur this disadvantage, the advantage was not extended to them. Once again, this is an example of a counterbalancing disadvantage: the disadvantage incurred by non-residents is explained by referring to a disadvantage incurred by residents, which the domestic measure at issue serves to remove.

The ECJ rejected this argument and held that *"the advantage which non-residents are presumed to enjoy arises, if at all, from the decision of the Netherlands legislature to abolish the right to deduct social security contributions."* That abolishment, by its nature, affects only taxpayers under an obligation to pay them. Accordingly, this circumstance may not be offset by a measure affecting the taxpayers not paying those contributions, since that would amount to penalizing them for not paying social security contributions in the Netherlands. The ECJ concluded: *"in any event, the alternative is this: either Mr Asscher is properly insured with the Belgian social security scheme alone and there can be no question of penalizing him by means of a tax differential for not paying social security contributions in the Netherlands; or he should be insured either exclusively or additionally with the Netherlands social security scheme, which would enable the Netherlands to claim social security contributions from him and would thus take him out of the 'foreign' scale of tax rates […]. Consequently, whether he is insured or not with one or the other national social security scheme is not a factor which can justify, in either of the two situations envisaged, the application of a higher rate of tax to a non-resident"*[1901].

As the argument of the Dutch government was a bit convoluted, the Court's response is not entirely straightforward. What it boils down to, however, is that the advantage for non-residents (if there is one, to begin with) cannot offset the disadvantage caused by the higher tax rate. Moreover, the Court wryly points out that the disadvantage incurred by residents of the Netherlands is caused by the decision of the Dutch legislature itself to abolish the right to deduct social security contributions. By its very nature, such a decision affects only taxpayers under an obligation to pay them. Accordingly, it would be absurd to offset this disadvantage against the tax disadvantage incurred by non-residents.

[1901] C-107/94, *Asscher*, § 53-54.

There was also a second disadvantage-issue in *Asscher*. The Dutch government argued that the higher rate applicable to non-residents was intended to offset the fact that certain non-residents escaped the progressive nature of the tax because their tax obligations were confined to income received in the Netherlands[1902]. This argument is based on the idea that the disadvantage incurred by the non-residents in question is a compensation for the progression benefit they enjoy due to their cross-border activity.

As mentioned earlier, the basic distinction in international taxation between unlimited tax liability of residents and limited tax liability of non-residents causes two related problems. On the one hand, taxpayers earning income abroad lose a proportional part of personal deductions (see I.A.b.1). On the other hand, taxpayers earning income abroad enjoy a progression benefit. The home State generally calculates progression of tax brackets on the basis of worldwide income and then applies the resulting rate only to the domestic part of the income. The source State generally calculates progression only on the basis of source income. Tax progression is therefore generally lower for taxpayers whose income is spread over different States as compared to taxpayers earning all their income in their home State. In *Asscher*, the Dutch government argued that the higher tax rate was in fact a compensation for the progression benefit enjoyed by the taxpayer.

The ECJ dismissed this argument. The Court referred to Art. 23A(1) and (3) OECD MC (as incorporated in Art. 24(2)(1) of the Belgian/Dutch tax treaty) which required the residence State to exempt the income exclusively taxable in the work State, but which allowed the residence State to take that income into account in calculating the amount of tax on the remaining income in order to apply the rule of progressivity. As a result of this provision, the fact that Mr Asscher was a non-resident *"[did] not enable him to escape the application of the rule of progressivity"*[1903].

In other words, the Court's reasoning starts from the observation that Mr Asscher was already subject to unlimited tax liability in his State of residence (Belgium) and that that State applied

[1902] A similar argument was brought forward in *Hollmann*, which concerned Portuguese legislation on the taxation of capital gains on immovable property. Non-residents were taxed at a fixed rate of 25% on the total amount of the capital gain, while residents were taxed at a progressive rate (with a maximum of 42%) on 50% of the amount of the capital gain. The Portuguese government argued that the reason why the basis of assessment was limited to 50% only for residents was that they were subject to a progressive tax rate on their entire income, while non-residents were taxed only on the income received in Portugal. In other words, the different treatment was introduced in order to avoid that residents would be penalised because of their being subject to a progressive tax (unlike non-residents). Moreover, the taxable income of residents resulted from the accumulation of different categories of income, including capital gains received each year. That aggregate income was subject to a progressive rate. In contrast, non-residents were subject to a special proportional rate on the capital gain derived in Portugal. Interestingly, however, the Portuguese government did not phrase this argument in terms of equal treatment, but in terms of comparability: it argued that residents and non-residents were not comparable because of the difference as regards the progressive taxation. The Court dismissed this argument, pointing out that: (1) the taxation of the capital gains resulting from the transfer of immovable property concerned only one of the categories of income received by taxable persons, whether they were resident or not; (2) that taxation concerned both residents and non-residents; and (3) the taxable income arose in Portugal in both cases (C-443/06, *Hollmann*, 11 October 2007, § 47-54). Put briefly, the situations were comparable because Portugal taxed both residents and non-residents on the same type of income arising in its territory. The fact that residents also earned other income in Portugal, which was aggregated and subject to progressive taxation, was irrelevant since the difference in treatment concerned one specific category of income.

[1903] C-107/94, *Asscher*, § 46-48. Remarkably, the Court concludes this argument by holding that *"both categories of taxpayer are therefore in comparable situations with regard to that rule"*. It is unclear why the Court refers to comparability when discussing an issue that clearly concerns the existence of a disadvantage.

an exemption with progression. From this observation, the Court seems to infer that Mr Asscher did not escape progressive taxation on his worldwide income. However, this line of reasoning is not entirely correct. While it is true that Mr Asscher did not escape progressive taxation on the Belgian part of his income, he did escape progressivity on the non-Belgian part. Belgium took account of Asscher's worldwide income when determining the applicable tax rate, but it applied that rate only to the Belgian part of his income. In the source State, the Netherlands, the tax rate on the income arising there was determined without taking account of income arising elsewhere. Therefore, Mr Asscher did escape progression on the part of his income arising in the Netherlands. The Court does not seem to fully appreciate the effect of this mechanism[1904]. However, even if the Court had taken account of the progression benefit enjoyed by Mr Asscher, the outcome would most likely have been the same, given the earlier case law that disadvantages cannot be offset by counterbalancing advantages (see supra).

6. Talotta

In *Talotta*, the Belgian government argued that the minimum tax bases provided for in the national legislation were often more favourable to non-resident taxpayers than the comparison-based taxation applied to resident taxpayers. The ECJ responds by paraphrasing its settled case law in respect of offsetting disadvantages: *"even on the assumption that the Belgian tax system is more often favourable to non-resident taxpayers, the fact remains that where that system proves disadvantageous for non-resident taxpayers, it results in unequal treatment by comparison with resident taxpayers and thus creates a hindrance to the freedom of establishment"*[1905].

So even if the offsetting advantage is inherent in the domestic regime at issue, the disadvantage has to be considered in isolation. In particular, the argument that the regime is more often favourable than detrimental is to no avail: as soon as the domestic regime is disadvantageous in one situation, the equal treatment-requirement has been violated, regardless of the number of situations in which the regime turns out to be advantageous[1906].

7. Lakebrink

Similarly, in *Lakebrink* (the facts of which have been set out in 2.E.I.A.b.1.b.2) the Luxembourg government argued that the disadvantage incurred by Mr and Mrs Lakebrink was compensated for by the fact that, overall, the Luxembourg measure was more favourable for non-residents as compared to residents because it took no account of unearned foreign income, whether negative or positive.

The ECJ dismissed this argument, holding that *"such a global assessment of the effects of the legislation cannot be upheld, because it would effectively render the prohibition laid down by*

[1904] Cf. also P. WATTEL, "Progressive taxation of non-residents and intra-EC allocation of personal tax allowances: why Schumacker, Asscher, Gilly and Gschwind do not suffice", *European Taxation* 2000, 213; C. VAN RAAD, "Fractionele belastingheffing van EU buitenlandse belastingplichtigen" in J. VERBURG (ed.), *Liberale gifte: vriendenbundel Ferdinand Grapperhaus*, Deventer, Kluwer, 1999, 302.
[1905] C-383/05, *Talotta*, § 31.
[1906] The same reasoning was applied in C-141/99, *AMID*, § 27: *"Even if the Belgian tax system were favourable to companies with establishments abroad more often than not, that does not prevent it resulting, where that system proves disadvantageous for those companies, in an inequality of treatment in relation to companies without establishments outside Belgium and thus creating a hindrance to the freedom of establishment guaranteed by Article 52 of the Treaty."*

Article 39 EC meaningless"[1907]. More specifically, legislation such as the Luxembourg measure may offer a tax advantage to non-resident taxpayers declaring unearned foreign income where that income is positive (or at least mostly positive), but the case is different for non-resident taxpayers such as Mr and Mrs Lakebrink, who have only negative unearned foreign income. The ECJ holds that the disadvantage incurred by non-residents such as Mr and Mrs Lakebrink *"cannot be compensated for by the fact that in other situations that same legislation does not discriminate between non-residents and residents. It is settled case-law that unfavourable tax treatment contrary to a fundamental freedom cannot be justified by the existence of other tax advantages, even supposing that such advantages exist"*[1908].

In his opinion in *Lakebrink*, the Advocate-General elaborates somewhat on this point, holding that *"any advantage that non-resident taxpayers may enjoy as compared with resident taxpayers in a similar situation is not sufficient to offset the disadvantage which they suffer in a case, such as the present one […]. To take the view that, because a disadvantage is not systematic, it is not liable to result in discrimination would be tantamount to regarding as compatible with the principle of freedom of movement for workers a tax regime which is only occasionally unfavourable to non-resident taxpayers, on the assumption that, being merely occasional, the disadvantage is of little significance. That would lead to minor forms of discrimination being tolerated, thereby rendering the general prohibition under Article 39 EC meaningless"*[1909].

8. Cadbury Schweppes

A final example of the Court's fundamental position that disadvantages have to be considered in isolation can be found in *Cadbury Schweppes*, the facts of which were discussed in 2.E.I.A.b.9.e. In that case, the question arose whether there was a disadvantage at all: the effect of the U.K. CFC rules was that CS paid no more tax than CSTS and CSTI would have paid if they had been established in the U.K. In the end, what the tax system tried to achieve was a neutral tax treatment, irrespective of the location of the subsidiary, by arranging that the overall tax burden on the economic unit consisting of a U.K. parent company and its subsidiaries was identical, irrespective of whether the subsidiaries were established in the U.K. or in another Member State.

The Court, however, dismissed this argument, by indicating that even though a resident company falling under the scope of the U.K. CFC legislation did not pay more tax than that which would have been payable on those profits if they had been made by a U.K. resident subsidiary, *"the fact remains that under such legislation the resident company is taxed on profits of another legal person. That is not the case for a resident company with a subsidiary taxed in the United Kingdom or a subsidiary established outside that Member State which is not subject to a lower level of taxation"*[1910].

[1907] C-182/06, *Lakebrink*, § 21.
[1908] C-182/06, *Lakebrink*, § 22-24, referring to C-385/00, *De Groot*, § 97.
[1909] Opinion of Advocate-General Mengozzi in *Lakebrink*, § 29.
[1910] C-196/04, *Cadbury Schweppes*, § 45. The Advocate-General took a similarly isolationist approach, by observing that the overall neutrality achieved by the U.K. legislation did not affect the analysis, as it did not *"eliminate the unequal treatment at the level of the parent companies"* (Opinion of Advocate-General Léger in C-196/04, *Cadbury Schweppes*, § 76).

d. The relevance of offsetting advantages in another State[1911]

1. Eurowings[1912]

In *Eurowings*, the Court held that a higher trade tax on German residents leasing goods from lessors established in another Member State, as compared to German residents leasing goods from lessors established in Germany, fell foul of the freedom to provide services. The taxable base in the German trade tax was computed by taking the tax base for corporate income tax purposes and adjusting it for certain add-backs and deductions. A lessee was required to add back 50% of the lease payments on leased fixed assets other than real estate plus the value of the leased asset, if the lessor was not liable to trade tax on these business profits. As only German residents or PEs were subject to trade tax, the trade tax base of the lessee was generally increased if the lessor was a non-resident.

The German government defended its regime by pointing out that the lessor was subject to lower taxation in its home State. Specifically, the German government argued that a lessor established in another Member State could charge the lessee a lower rental free because he is not liable to trade tax. By contrast, a lessor established in Germany who is liable to trade tax would pass it on to the lessee by incorporating it in the rental fee. Therefore, the German government held that the add-backs *"serve to balance the lower rent paid by the lessee to the lessor established in another Member State. The latter is not placed at any competitive disadvantage by those add-backs, however, as in both cases the burden of the tax is the same and falls to be paid ultimately by the lessee established in Germany."*

The Court did not accept this argument, and held that *"any tax advantage resulting for providers of services from the low taxation to which they are subject in the Member State in which they are established cannot be used by another Member State to justify less favourable treatment in tax matters given to recipients of services established in the latter State"*[1913]. Consequently, it makes no difference where the offsetting advantage is located – whether in the State whose tax regime is under scrutiny, or elsewhere – the Court refuses to acknowledge that it may remove the disadvantage. The disadvantage has to be examined in isolation, without any interference from counterbalancing advantages[1914].

[1911] The issue discussed here is whether a disadvantage that is caused by a domestic measure of one Member State can be removed by an offsetting advantage in another State's domestic law. At first glance, this notion may seem contrary to the Court's position on disparities. As will be discussed in 2.E.II, the Court has consistently held that disadvantages caused by the interplay of different domestic tax systems go beyond the scope of the fundamental freedoms. So if the Court refuses to consider the interplay between different domestic tax systems when assessing the **existence** of a disadvantage, why would it take account of that interplay when determining whether an existing disadvantage is **removed**? The reason is simple: a disparity occurs when taxpayers suffer a disadvantage because different tax systems, which are all compatible with the fundamental freedoms, interact. Consequently, none of the Member States involved can be blamed for enacting or applying measures that infringe the freedoms. It would therefore be impossible for the Court to decide which State should remedy the disadvantage. The situation is different where one Member State acts in breach of the fundamental freedoms, but the resulting disadvantage is counterbalanced by an advantage in another State. In that case, there are no conceptual arguments against the Court assigning blame and there is, therefore, no reason not to apply the fundamental freedoms, including the disadvantage-test.

[1912] C-294/97, *Eurowings Luftverkehrs AG v Finanzamt Dortmund-Unna*, 26 October 1999, *ECR* 1999, I-07447.

[1913] C-294/97, *Eurowings*, § 44.

[1914] The same reasoning was followed in C-136/00, *Danner*, 3 October 2002, § 56. The same approach was also taken in cases concerning inheritance taxes: cf. C-11/07, *Eckelkamp*, § 68-69 and C-43/07, *Arens-Sikken*, 11 September 2008, § 65-66: *"The Member State in which the immovable property included in the estate is situated cannot, in order to justify a restriction on the free movement of capital arising from its legislation, rely on the existence of a possibility, beyond its control, of a tax credit being granted by another Member State – such as the*

2. Verkooijen

This approach was upheld in *Verkooijen*, which was already discussed in 2.E.I.A.b.6.b.1. In that case, the Dutch government defended the legislation at issue by arguing that applying the dividend exemption to shareholders of non-resident companies would enable such shareholders to secure a two-fold advantage since they could enjoy tax reliefs both in the source State of the dividend and in their State of residence[1915]. Accordingly, the Dutch government suggests that resident taxpayers receiving foreign-sourced dividends are not treated less favourably than resident taxpayers receiving domestic dividends, as the former enjoy tax reliefs in the source State and the latter in their State of residence. Both categories receive similar tax reliefs, albeit in different Member States. Granting tax reliefs in the Netherlands to residents receiving foreign-sourced dividends would lead to an additional benefit for that category as compared to residents receiving domestic dividends. In order to avoid such a difference in treatment, the Netherlands did not grant the exemption with respect to foreign-sourced dividends.

Consequently, the offsetting advantage in this case was the tax relief granted in the source State. The ECJ dismisses this argument by paraphrasing its earlier case law: *"it is clear from settled case-law that unfavourable tax treatment contrary to a fundamental freedom cannot be justified by the existence of other tax advantages, even supposing that such advantages exist"*[1916].

3. Lenz

A similar argument was brought forward in *Lenz*: if the corporation tax in another State was lower than in Austria and the tax advantage at issue (the reduced tax rate) was extended to foreign-sourced dividends, that would make it advantageous for Austrian residents to buy shares of companies established in those Member States. Once again, the ECJ disagreed. The Court first observed, quite broadly, that *"the level of taxation on companies established in another Member State is not relevant in relation to Austrian tax legislation when assessing the compatibility of national legislation with [the free movement of capital]"*[1917]. This is a confirmation of the Court's traditional position that the measure at issue (i.e., the disadvantage it causes) has to be considered in isolation, without interference from counterbalancing advantages, such as lower tax rates in another Member States.

In order to support this argument, the Court refers to the absence of a direct link between the corporation tax at the level of the distributing company and the tax advantages enjoyed by the resident shareholder. *"In those circumstances, the level of the taxation of companies established outside Austrian territory cannot justify a refusal to grant those same financial advantages to persons receiving revenue from capital paid by those latter companies"*[1918].

Member State in which the person whose estate is being administered was residing at the time of death – which could, wholly or partly, offset the loss incurred by that person's heirs as a result of the fact that, in the Member State in which the property inherited is situated, debts secured on that property are not deductible for the purposes of assessing transfer duties […]. A Member State cannot rely on the existence of a tax advantage granted unilaterally by another Member State – in the present case, the Member State in which the person concerned was residing at the time of her death – in order to escape its obligations under the Treaty and, in particular, under the Treaty provisions relating to the free movement of capital."

[1915] C-35/98, *Verkooijen*, § 54.
[1916] C-35/98, *Verkooijen*, § 61.
[1917] C-315/02, *Lenz*, § 41.
[1918] C-315/02, *Lenz*, § 42.

The Court then immediately adds that the possibility cannot be excluded that extending the tax benefits to foreign-sourced dividends might make it advantageous for Austrian investors to buy shares of companies established in other Member States, where corporation tax is lower than in Austria. However, *"that possibility is in no way capable of justifying legislation such as that at issue in the main proceedings. As regards an argument based on a possible tax advantage for taxpayers receiving in their country of residence dividends from companies established in another Member State, it is clear from settled case-law that unfavourable tax treatment contrary to a fundamental freedom cannot be justified by the existence of other tax advantages, even supposing that such advantages exist"*[1919].

4. De Groot

In the *De Groot*-case, the facts of which were set out in 2.E.1.A.b.1.a.6, the Dutch government argued that the disadvantage suffered by a taxpayer such as Mr De Groot was to a large extent compensated for by a progressivity advantage (i.e. the 'salary split': workers who are taxed in each State of employment only in part of their income are at an advantage as regards income tax progression[1920]). The Advocate-General of the Dutch Supreme Court explained this offsetting advantage as follows: *"The disadvantage of the 'disappearance' of 60% of his tax reduction is compensated for by an advantage: he derives income in three source States, none of which takes into account the income derived outside its territory in order to calculate the tax progression. As a result, he enjoys a significant advantage as regards progressivity. If the three source States concerned were, like the State of residence, to take account of the amount of total income when determining the rate of income tax to be levied by the source State, he would, given the level of his total income in 1994 (even after deduction of his personal allowances), fall within higher tax bands in the three source States and would therefore pay more tax. It is at present unusual for a source State to require taxpayers abroad to declare their total income in order to reserve a right to apply a progressivity clause, like the State of residence, and to require a declaration of personal circumstances in order to take account thereof proportionally like the State of residence"*[1921].

Once again, the ECJ held that *"detrimental tax treatment contrary to a fundamental freedom cannot be justified by the existence of other tax advantages, even if those advantages exist"*[1922].

[1919] C-315/02, *Lenz*, § 43, referring to C-35/98, *Verkooijen*, § 61.
[1920] Interestingly, the same argument was advanced by the Luxembourg government in *Biehl* in the form of a justification ground. In particular, the argument was that the Luxembourg rule at issue in that case was intended to *"protect the system of progressive taxation"*. Its purpose was to avoid the distortion of that system which would occur if a taxpayer could spread his tax liability between two Member States. However, the ECJ dismissed that argument (C-175/88, *Biehl*, § 16). See also supra, 2.E.I.B.c.5: in *Asscher*, the same argument was brought forward from the perspective of the source State. So in *Asscher*, it concerned a counterbalancing advantage (the progression benefit) in the (allegedly) discriminating State. In *De Groot*, the counterbalancing advantage (the progression benefit) was in other States, i.e. the source States.
[1921] C-385/00, *De Groot*, § 38. The Belgian government made a similar observation, and argued that *"taxpayers exercising their right to free movement often enjoy a considerable tax advantage, namely the 'salary split' mechanism. Workers who, like Mr De Groot, are taxed in each State of employment only on part of their income are at an advantage as regards income tax progression. The tax advantage which non-resident workers thus enjoy over resident workers as a result of the lack of tax progression is contrary to the principle of tax equity, which requires that taxpayers be taxed in accordance with their ability to pay. According to the Belgian Government, a non-resident worker will always pay less tax than a resident worker on the same income"* (C-385/00, *De Groot*, § 61-62).
[1922] C-385/00, *De Groot*, § 97.

e. The relevance of tax treaties in the disadvantage-test

As discussed in 2.E.I.A.b.9, the comparability-test may be influenced by the existence of tax treaties. Similar issues arise in the disadvantage-test. More specifically, it could be argued that a disadvantage caused by the tax laws of a Member State is subsequently removed by the provisions of a tax treaty. As will become apparent below, the ECJ has taken a different approach in respect of such offsetting tax treaty advantages than it has taken as regards offsetting domestic advantages.

1. Avoir Fiscal

As mentioned in 2.E.I.B.c.1, the French government argued that the disadvantage (i.e. the absence of the tax credit) would be removed by adding additional provisions to the existing tax treaties between France and other Member States, in order to extend the tax credit on the basis of reciprocity. As a result of such provisions, foreign companies having a PE in France would benefit from the credit if the same concession was granted to French companies having a PE in the other Member State.

Advocate-General Mancini dismissed this argument, thereby referring to earlier case law[1923], in which the ECJ had held that the freedom of establishment may not be restricted by any reciprocity clause[1924]. The Court followed this reasoning, and held that *"the rights conferred by [the freedom of establishment] are unconditional and a Member State cannot make respect for them subject to the contents of an agreement concluded with another Member State. In particular, that Article does not permit those rights to be made subject to a condition of reciprocity imposed for the purpose of obtaining corresponding advantages in other Member States"*[1925].

From this reasoning, one could infer that the disadvantage-test is left unaffected by tax treaty provisions. Consequently, neither tax treaty provisions, nor domestic provisions (see 2.E.I.B.c.1) would be able to remove the disadvantage. As will become apparent below, however, there are some reservations to be made in respect of tax treaties.

2. Manninen

The question as to whether tax treaty-provisions can affect the disadvantage-test has been addressed to a significant extent in the ECJ's case law on double taxation of dividends. An early example is the *Manninen*-judgment, in which the Convention between Member States of the Nordic Council for the avoidance of double taxation came up for discussion. Pursuant to the provisions of that convention, the tax deducted at source in Sweden (the rate of which was capped at 15% by virtue of Article 10 of the convention) was deductible from the income tax due by the Finnish resident shareholder on the dividends.

The ECJ decided that this provision was not sufficient to neutralise the disadvantage: *"it is undisputed that the tax convention concluded between the States of the Nordic Council for the*

[1923] Case 159/78, *Commission v Italy*, *ECR* 1979, 3247. The Italian customs legislation contained a provision under which the licence to act as a customs agent was granted only to Italian nationals or nationals of other States *"that grant equal treatment […] to Italian citizens"*. The Court held that provision to be incompatible with the freedom of establishment precisely because it did not make an exception in favour of EU citizens.
[1924] Opinion of Advocate-General Mancini, 16 October 1985, *ECR* 1986, 273, § 7.
[1925] C-270/83, *Avoir fiscal*, § 26.

prevention of double taxation is not capable of eliminating that unfavourable treatment. That convention does not provide for any system for setting off corporation tax against income tax due on revenue from capital. It merely seeks to attenuate the effects of double taxation in the hands of the shareholder in relation to that latter tax"[1926]. It could thus be argued *a contrario* that, in the opposite scenario (i.e. where the applicable tax treaty provides for *"a system for setting off corporation tax against income tax due on revenue from capital"*), the disadvantage could be removed by the tax treaty. This idea seems to have been confirmed subsequently in *Bouanich*.

3. Bouanich[1927]

As explained in 2.E.I.A.b.2.e, *Bouanich* concerned the deductibility by the shareholder of the acquisition costs upon the share repurchase by the Swedish company. As regards the influence of the applicable tax treaty on that issue, the ECJ first observed that the tax treaty in question was based on the OECD MC, and then referred to Comm. OECD on Article 10, § 28, which states that payments regarded as dividends include not only the disbursement of profits decided at the annual shareholders' meeting but also other advantages with monetary value, such as bonus shares, bonuses, profits on liquidation and hidden dividends. The tax reliefs set out in that article are valid for as long as the paying company's State of residence taxes such advantages as dividends. Moreover, Comm. OECD on Article 13, § 31 states that if a shareholder sells shares to the company that issued them, in connection with a liquidation of that company or a reduction in its share capital, the difference between the sale price and the nominal value of the shares may be treated as a distribution of accrued profits and not as a capital gain in the company's State of residence. That article does not prevent the company's State of residence from taxing such a dividend according to the tax rates laid down in Article 10 OECD MC. Such taxation is permitted because the difference is included in the definition of the expression 'dividend' in Article 10(3), as interpreted at point 28 of the commentary on that Article. Finally, the ECJ noted that the tax treaty, as interpreted in the light of the OECD MC and the Comm. OECD, brought about a change in the Swedish tax system, in that it fixed the dividend tax rate for non-residents at 15% and permitted an amount corresponding to the nominal value of the repurchased shares to be deducted[1928].

Accordingly, the question arose whether the issue discussed in 2.E.I.A.b.2.e would be influenced by the existence of a tax treaty pursuant to which a shareholder, with reference to the Comm. OECD, was also permitted a deduction from the share repurchase payment corresponding to the nominal value of the repurchased shares. Referring to *Avoir fiscal* and *Saint Gobain*, the Commission argued that compliance with the fundamental freedoms could not be dependent on the content of a tax treaty between two Member States. As a result, the Swedish system – including the provisions of the tax treaty interpreted in the light of the OECD Commentaries – was contrary to the free movement of capital.

However, the ECJ took another approach and did not dismiss the relevance of the tax treaty out of hand. The Court held that it was necessary to consider whether the tax treaty had to be *"taken into account in determining whether tax legislation is consistent with Community rules on the free movement of capital. If that is the case, it falls then to be established* ***whether that agreement removes the restriction*** *on fundamental freedom that has been found to exist"*[1929].

[1926] C-319/02, *Manninen*, § 21.
[1927] ECJ 19 January 2006, C-265/04, *Margaretha Bouanich v Skatteverket*.
[1928] C-265/04, *Bouanich*, § 13-16.
[1929] C-265/04, *Bouanich*, § 46-48, emphasis added.

In other words, the Court envisions a two-step analysis. First, it has to be determined whether the tax treaty is relevant in assessing the compatibility of the national measure with the free movement provisions. If the result of the first step is affirmative, then it must be verified whether the tax treaty removes the restriction (i.e. removes the disadvantage). This seems to be a notable departure from the Court's earlier case law, where the relevance of offsetting advantages was consistently dismissed.

After referring to its *Gilly*-interpretation of the former Article 293 EC, the Court takes the first step of the proposed two-step analysis: *"since the tax system under the Franco-Swedish agreement, as interpreted in the light of the commentaries on the OECD Model Tax Convention, forms part of the legal background to the main proceedings and has been presented as such by the national court, the Court of Justice must take it into account in order to give an interpretation of Community law that is relevant to the national court"*[1930]. The ECJ then recalls that the tax treaty (as interpreted according to the OECD Commentaries) permits non-resident shareholders to deduct the nominal value of the shares from the taxable amount payable on the occasion of a repurchase of those shares. The remaining amount is then taxed at the rate of 15%. Thus, the Court concludes that, *"in view of the fact that resident shareholders are taxed at the rate of 30% on share repurchase payments after deduction of the cost of acquisition, it must be ascertained* ***whether those shareholders are treated more favourably than non-resident shareholders****"*[1931]. However, that analysis requires factual information to be taken into account (i.e. the acquisition cost of the shares and their nominal value). As the assessment and finding of the facts in a case are not matters for the ECJ but for the national court, the ECJ refers the remainder of the analysis back to the national court.

The ECJ therefore decides that it is *"a matter for the national court to determine in the proceedings before it whether the fact that non-resident shareholders are permitted to deduct the nominal value and are liable to a maximum tax rate of 15%* ***amounts to treatment that is no less favourable*** *than that afforded to resident shareholders, who have the right to deduct the cost of acquisition and are taxed at a rate of 30%"*[1932]. This means that the Court opens the possibility for national courts to determine whether the disadvantage created by the domestic legislation is removed by the provisions of a tax treaty. In particular, if the combined effect of the domestic legislation and the provisions of the tax treaty entails a treatment of non-residents which is **not less favourable** than the treatment of residents, then the disadvantage has been removed.

4. ACT

In *ACT*, the ECJ did not address the question as to the influence of the tax treaty on the disadvantage-test[1933], but the Advocate-General made some relevant remarks in his Opinion. After confirming the principle that tax benefits granted by the source State to non-residents should equal those granted to residents insofar as the source State otherwise exercises equal tax jurisdiction over both groups, the Advocate-General makes the following observation: *"it*

[1930] C-265/04, *Bouanich*, § 49-51.
[1931] C-265/04, *Bouanich*, § 52, emphasis added.
[1932] C-265/04, *Bouanich*, § 55, emphasis added.
[1933] However, the ECJ noted that it was *"for the national court to determine, in each case, whether that obligation [(i.e. the obligation of equal treatment)] has been complied with, taking account, where necessary, of the provisions of the DTC that that Member State has concluded with the State in which the shareholder company is resident"* (*ACT*, § 71, referring to *Bouanich*, § 51-55). Moreover, the Court assessed the influence of the applicable tax treaty on the comparability-test (cf. 2.E.I.A.b.9.b).

is none the less in my view open to a Member State to ensure the fulfilment of its obligations under the Treaty free movement provisions by means of provisions contained in a DTC. Thus, taking the example of a source State imposing domestic economic double taxation on its non-residents in the same way as on its residents, it is in my view open to that source State to ensure that its non-residents receive the same double taxation relief as its residents by virtue of a DTC. In such a situation, however, the extent of double taxation relief granted to non-residents must be equivalent to that granted to residents. In this regard, I would concur with the approach taken by the Court in its judgment in Bouanich holding that, in a case where a State exercised the same tax jurisdiction over its non-resident shareholders as over its resident shareholders, it was for the national court to assess whether, taking the applicable DTC into account, residents were treated more favourably than non-residents"[1934].

The Advocate-General thus applies the *Bouanich*-reasoning to a case concerning the double taxation of dividends: the possible disadvantage incurred by non-residents, consisting of the double taxation of dividends, may be removed by the provisions of a tax treaty. It is, however, for the national court to assess whether the tax treaty succeeds in doing so[1935]. The Advocate-General gives two reasons why the effect of tax treaties is relevant in assessing whether Member States' tax systems are compatible with the fundamental freedoms. First, the Member States are free to apportion between themselves not only tax jurisdiction but also priority to taxation. Thus, it is open to the source State which imposes double economic taxation on dividends to ensure, by tax treaty, that this will be relieved by the home State. Second, if the effect of the tax treaty in an individual case were not taken into account, this would ignore the economic reality of that taxable subject's activity and incentives in a cross-border context. Put otherwise, it could distort the real effect on that taxpayer of the combination of home and source State obligations. The Advocate-General then stresses that, *"in such a scenario, it would form part of the source State's Treaty [free movement] obligations to ensure that this result has been achieved. It would be no defence, for example, to argue that the home State had been in breach of its DTC obligations by failing to relieve the relevant economic double taxation"*[1936].

5. Denkavit

As mentioned earlier, a second issue in *Denkavit* concerned the influence of the provisions of the France/Netherlands tax treaty on the French regime's compatibility with the Treaty freedoms. By virtue of the tax treaty, a parent company which was resident in the Netherlands could, in principle, offset the 5% withholding tax paid in France against its liability to tax in the Netherlands (see supra). Accordingly, it could be argued that the French withholding tax was merely a means of apportioning the taxable item between the Member States concerned, which was not open to challenge under the Treaty freedoms. On the other hand, a parent company resident in the Netherlands was in fact unable to set off tax as provided for by the tax treaty. As the amount offset could not exceed the amount of Dutch tax otherwise payable on those dividends and Dutch parent companies were exempted in the Netherlands from tax on foreign-sourced dividends, no credit was given in respect of French withholding tax.

[1934] Opinion of Advocate-General Geelhoed in C-374/04, *ACT*, § 70.
[1935] The Court implicitly confirms this in the statement, quoted above, that it was *"for the national court to determine, in each case, whether [the obligation of equal treatment] has been complied with, taking account, where necessary, of the provisions of the DTC that that Member State has concluded with the State in which the shareholder company is resident."*
[1936] Opinion of Advocate-General Geelhoed in C-374/04, *ACT*, § 71.

After confirming that the tax regime arising under the tax treaty formed part of the legal framework applying to the main proceedings and that the ECJ therefore had to take it into account in its interpretation of EU law[1937], the Court observed that the combined application of the tax treaty and the relevant Dutch legislation *"does not serve to overcome the effects of the restriction on freedom of establishment that was held to exist in the answer to Question 1"*[1938].

Under the tax treaty and the relevant Dutch legislation, a parent company established in the Netherlands which received dividends from a French subsidiary was liable to withholding tax, capped by the treaty at 5 % of the amount of the dividends, while a parent company established in France was almost fully exempt from tax on those dividends. Unsurprisingly, the Court held that the limited extent of the disadvantage did not affect the outcome of the disadvantage-test: *"irrespective of its extent, the difference in tax treatment resulting from the application of that convention and that legislation constitutes discrimination against parent companies on the basis of their registered office, which is incompatible with the freedom of establishment guaranteed by the Treaty. A restriction on freedom of establishment is prohibited by Article 43 EC, even if it is of limited scope or minor importance"*[1939]. Put briefly, the Court decided that the mitigation of the disadvantage by the tax treaty did not influence the analysis: any disadvantage is prohibited, even if it is of limited scope.

However, the Court immediately adds that the case at hand was more complicated than that: the combined effect of the tax treaty and the relevant Dutch legislation made it impossible for Dutch parent companies to avoid double taxation on the dividends received from their French subsidiaries. As a result, the Court decided that the freedom of establishment had to be interpreted *"as precluding national legislation which imposes, only as regards non-resident parent companies, a withholding tax on dividends paid by resident subsidiaries, even if a tax convention between the Member State in question and another Member State, authorising that withholding tax, provides for the tax due in that other State to be set off against the tax charged in accordance with the disputed system, whereas a parent company is unable to set off tax in that other Member State, in the manner provided for by that convention"*[1940].

In other words, the possibility provided for in a tax treaty to credit the tax paid in the source State against the tax due in the home State could not remove the disadvantage, because the combined effect of the tax treaty and the home State legislation made it impossible *in casu* to apply the credit. This might imply that the disadvantage **can** be removed in the opposite situation, i.e. where the tax treaty allows the tax withheld at source to be credited in the home State and the home State legislation does not preclude the actual application of the credit.

6. Amurta

A thorough analysis of these issues was given in *Amurta*. The second question asked in that case was whether the disadvantage caused by the Dutch tax system could be removed by the existence of a full tax credit, granted by the recipient shareholder's State of residence. The ECJ first referred to its earlier position that unfavourable tax treatment contrary to the fundamental freedoms cannot be offset by the existence of other tax advantages, even supposing that such advantages exist (see supra). Given its the discriminatory treatment of

[1937] C-170/05, *Denkavit*, § 45, referring to *Manninen*, § 21, *Bouanich*, § 51 and *ACT*, § 71.
[1938] C-170/05, *Denkavit*, § 47.
[1939] C-170/05, *Denkavit*, § 49-50.
[1940] C-170/05, *Denkavit*, § 58.

outbound dividends, the Netherlands could not rely on the existence of a tax advantage granted unilaterally by another Member State in order to escape its obligations under the Treaty freedoms.

However, the ECJ immediately adds its traditional reasoning with respect to tax treaties: *"it cannot be excluded that a Member State may succeed in ensuring compliance with its obligations under the Treaty through the conclusion of a convention for the avoidance of double taxation with another Member State"*[1941]. After reiterating the *Bouanich*-argument on the relevance of tax treaties in the disadvantage test (see supra), the ECJ noted that the referring court had not referred to the relevant provisions of the tax treaty in the order for reference. Since it was for the national court to identify the law applicable to the proceedings, the Court decided that the national court had to establish whether the tax treaty had to be taken into account and, if so, to determine whether that treaty enabled the disadvantage to be neutralised[1942].

Thus, *Amurta* illustrates the dichotomy in the Court's attitude towards offsetting advantages. On the one hand, the discriminating Member State cannot rely on compensating advantages granted unilaterally **by that Member State** (see 2.E.I.B.c) or **by another Member State** (see 2.E.I.B.d). However, it cannot be excluded that the disadvantage may be neutralised **by a tax treaty** concluded by that first Member State. In other words, **unilateral** measures cannot remove a disadvantage, while **bilateral** measures may be able to do so[1943].

7. Thin Cap GLO

In *Thin Cap GLO* (see supra, 2.E.I.A.b.5.c), the U.K. government argued that the disadvantage at issue was, in most cases, removed by the provisions of the applicable tax treaty: most of the tax treaties concluded by the U.K. contained a provision permitting the respective competent authorities to agree a compensating adjustment, whereby any increase in taxable profits in the State of the borrowing company was matched by a corresponding reduction in taxable profits in the State in which the lending company was established[1944].

The Court responded to this argument by pointing out that the tax treaty formed part of the applicable legal framework and should therefore be taken into account in verifying whether the national measure was compatible with EU law[1945]. However, the documents before the Court did not show that where U.K. law treated interest paid by a resident company to a related non-resident company as a profit distribution, the application of that national legislation coupled with the relevant provisions of a tax treaty *"generally allows the increase in the charge to tax arising from the adjustment made to the taxable profits of the borrowing company to be offset"*. As a result, it was not clear that the tax disadvantage inflicted on a group of companies as a result of the application of the U.K. thin cap-rules was always matched by a corresponding advantage in the borrowing company's State of residence. From this, it follows that the disadvantage must be neutralised **in every situation**. If not, the tax treaty provisions are insufficient to remove the disadvantage.

[1941] C-379/05, *Amurta*, § 75-79, referring to C-374/04, *ACT*, § 71.
[1942] C-379/05, *Amurta*, § 80-83.
[1943] Arguably, the same is true for measures provided for in multilateral instruments. Additionally, it seems that offsetting advantage provided for by secondary European law, such as the Parent/Subsidiary Directive, can also remove the disadvantage: see C-284/06, *Burda*, § 89-94. For a discussion of this judgment, see 2.E.I.C.a.2.
[1944] C-524/04, *Thin Cap GLO*, § 48.
[1945] C-524/04, *Thin Cap GLO*, § 54, referring, *inter alia*, to C-319/02, *Manninen* and C-265/04, *Bouanich*.

8. Commission v Italy[1946]

As a final example, consider this case concerning the Italian tax regime on outbound dividends, which was discussed in 2.E.I.A.b.8.b.4. Since dividends paid by a resident company to another resident company were exempt from tax in the amount of 95% while dividends paid by a resident company to a non-resident company were subject to a 27% withholding tax, the measure was clearly discriminatory. The Italian government nevertheless argued that, in reality, dividends paid to non-resident companies were not treated differently from dividends paid to resident companies, because tax treaties allowed the tax withheld at source in Italy to be set of against the tax due in the other Member State[1947].

The ECJ first acknowledges its earlier case law in this field (referring to *ACT* and *Amurta*), according to which a Member State might possibly succeed in ensuring compliance with its obligations under the Treaty freedoms by concluding a tax treaty with another Member State. However, the Court immediately adds that it is necessary for that purpose that the tax treaty allows the effects of the difference in treatment introduced by the national legislation to be compensated for. In particular, the difference in treatment between dividends distributed to companies established in other Member States and those distributed to resident companies *"does not totally disappear unless the tax withheld at source under national legislation can be set off against the tax due in the other Member State* ***in the full amount*** *of the difference in treatment arising under the national legislation"*[1948].

In the present case, a full set-off against the tax due in the other Member State of the tax withheld at source in Italy was not guaranteed. Such a set-off presupposes that Italian-sourced dividends are sufficiently taxed in the other Member State. And that is a matter for the other Member State to decide. If those dividends are not taxed (or are not sufficiently taxed) in that State, the sum withheld at source in Italy (or a part thereof) cannot be set off. In that case, the difference in treatment caused by the Italian legislation cannot be compensated for by applying a tax treaty. As a result, the application of tax treaty provisions did not (entirely) remove the disadvantage in every situation[1949].

f. Conclusion: the Court's position on offsetting advantages

The Court's basic position as regards counterbalancing advantages is that discriminatory measures should be assessed in isolation, without interference from extraneous factors. As a result, counterbalancing advantages are unable to remove the discrimination, regardless of the Member State in which they are provided for. However, two remarks are in order. First, the Court sometimes refrains from using the strict *Avoir fiscal*-argument that *"even if such advantages actually exist, they cannot justify a breach of the obligation to accord non-residents the same treatment as is accorded to residents"*. Instead, the Court seems to weigh the advantage enjoyed by the subject of comparison against the disadvantage suffered. However, the result of this analysis is always that the disadvantage outweighs the advantage, so it is not certain whether the Court would ever accept this argument.

[1946] C-540/07, *Commission v Italy*, 19 November 2009.
[1947] C-540/07, *Commission v Italy*, § 35.
[1948] C-540/07, *Commission v Italy*, § 37, emphasis added.
[1949] C-540/07, *Commission v Italy*, § 38-40.

Secondly, as regards tax treaties, it may seem difficult at first sight to reconcile *Avoir fiscal* with the *Bouanich*-type of cases. In its disadvantage-test in *Avoir fiscal*, the Court seems to take the same approach with respect to tax treaties as it has taken with respect to domestic provisions: the measure under scrutiny must be examined in isolation, without interference from provisions which are external thereto (whether they originate in domestic law or in tax treaties) and without considering that the measure at issue may also be beneficial in certain cases (e.g. *Talotta*). In *Bouanich*, however, the Court seems to accept the idea that tax treaty provisions may remove the disadvantage.

However, there is an important difference between both cases. In *Avoir fiscal*, the Court decided that a Member State cannot subject its compliance with the Treaty freedoms to a condition of reciprocal application of tax treaty provisions (or let that compliance in any other way depend on the content of a treaty concluded with another State). More specifically, a Member State must not subject its compliance with the duties imposed by the free movement provisions to a condition of reciprocity. In *Bouanich*, by contrast, there was no condition of reciprocity. Unlike in *Avoir fiscal*, there was no attempt in *Bouanich* to explain the disadvantage by referring to the absence of a tax treaty between the Member States involved. On the contrary, the opposite issue was at stake, i.e. whether **the application of a tax treaty which already existed** could remove the disadvantage[1950] [1951].

So a distinction must be drawn between two types of offsetting advantages. On the one hand, purely domestic (i.e. unilateral) beneficial measures cannot offset the disadvantage. It makes no difference whether it concerns measures in the State whose tax system is under scrutiny or in another State. Moreover, it follows from *Talotta* that even benefits which are **inherent** in the measure under scrutiny cannot remove the disadvantage. On the other hand, beneficial

[1950] A similar analysis is made by Advocate-General Kokott in her Opinion in C-265/04, *Bouanich*, § 42 *et seq*. The Advocate-General also distinguishes *Bouanich* from earlier case law in another respect. Referring to *Avoir fiscal*, *Saint Gobain*, *Verkooijen*, etc., the A.-G. observes that a tax disadvantage which infringes a fundamental freedom cannot be removed by *"the possible existence of other advantages which have nothing to do with the individual case in question"* (§ 47 of the Opinion). In those cases, reference was made to *"entirely unrelated **general advantages** which did not directly have anything to do with the actual application of the legal provisions at issue in the main proceedings in each particular case […] for example, in Eurowings […] it was attempted to offset existing tax disadvantages in one Member State against tax advantages in another Member State"* (footnote 45 of the Opnintion). According to the Advocate-General, *Bouanich* should be distinguished from that line of earlier cases, as *Bouanich* did not concern *"consideration of some supposed distant advantages which have nothing to do with the individual case in hand, rather at issue is an assessment of the effects of the legal provisions which actually apply in Sweden to the individual case in hand, [including the tax treaty between Sweden and France]"* (§ 50 of the Opinion). However, it is difficult to reconcile this interpretation with the Court's judgment in *Talotta*, where the **inherent** beneficial effects of the legislation at issue were dismissed in clear terms as well (see 2.E.I.B.c.6). The offsetting advantages to which the Belgian government referred in *Talotta* can therefore not be characterised as *"some supposed distant advantages which have nothing to do with the individual case in hand."* On the contrary, it concerned *"the effects of the legal provisions which actually apply […] to the individual case in hand."* Thus, it seems that there is another reason why, unlike in *Asscher*, *Talotta*, etc., the offsetting advantages in *Bouanich* were not dismissed out of hand. In my opinion, the reason is the bilateral nature of the obligation from which the offsetting advantage arises in *Bouanich*, in contrast to the unilateral nature of the measures which were unsuccessfully invoked in *Asscher*, *Talotta* and similar case law.

[1951] See also the Opinion of Advocate-General Mengozzi in C-379/05, *Amurta*, § 81: *"the State whose legislation is in itself contrary to Community principles must continue to be under a duty to neutralise such distorting effects of its legislation, without being able to escape its obligations under the Treaty by citing the failure of the other contracting party to take the measures provided for in the DTC."* That may be another aspect of the idea of reciprocity as relied on in *Avoir fiscal*. Indeed, it would be unacceptable if the discriminating State could rely on a bilateral instrument in order to establish that the disadvantage is removed, where that bilateral instrument is subject to a 'strict type' of reciprocity, in that the failure of one party to comply with its obligations under that instrument would absolve the other party of its own obligations (see also Part II, 2.B.VII).

measures of a bilateral nature may offset the disadvantage, but this requires a factual assessment by the national court. In particular, it is necessary that the application of the tax treaty provisions allows the disadvantage to be effectively removed in the full amount, and that removal must not depend on the unilateral actions of a Member State[1952]. Furthermore, the disadvantage must be neutralised in every situation.

> This approach has some important implications. In particular, it seems that an exemption or an ordinary credit provided for in a tax treaty is insufficient to meet these conditions: only a full credit will do[1953]. Under an ordinary credit mechanism, the residence State grants a credit to its residents for foreign tax paid on foreign-sourced income, but that credit is limited to the amount of tax that the residence State would otherwise have collected on the foreign source income. This is normally done by allocating a proportionate share of the resident's total income tax liability in the residence State on his worldwide income to his foreign source income. Such an ordinary credit would not meet the conditions set out by the ECJ, since it does not fully remove the disadvantage in every situation. In particular, where the tax rate in the source State is higher than that in the residence State, the foreign tax paid will not be entirely compensated for. As a result, in situations such as *Commission v Italy*, the disadvantage would remain for cross-border transactions.
>
> Consequently, the tax treaty can only fully remove the disadvantage in every situation if it provides for a full credit[1954], which entails that the residence State grants its residents a credit for the whole amount of the tax paid on the foreign-sourced income in the source State (even if no tax is levied on that income in the residence State)[1955]. However, full credit mechanisms are generally not included in tax treaties because of their detrimental effect on the residence State's tax revenue. Consequently, the possibility that a tax treaty can fully remove the disadvantage seems theoretical.
>
> The result of this approach seems to be that the source State will generally be unable to rely on offsetting advantages to establish that the disadvantage is removed, irrespective of whether those advantages are provided for in a unilateral or in a bilateral instrument. The obligation to remove the disadvantage will thus fall on the

---

[1952] See e.g. C-540/07, *Commission v Italy*, where the disadvantage could only be removed in the full amount if the dividends were sufficiently taxed in the other Member State

[1953] M. LANG, "ECJ case law on cross-border dividend taxation – Recent developments", *EC Tax Review* 2008, 71; J. ENGLISCH, "Taxation of cross-border dividends and EC fundamental freedoms", *Intertax* 2010, 219; M. DASSESSE, "Belgian Withholding Taxes on Outbound Dividends and Interest: The Challenge of Community Law", *Bull. IBFD* 2008, 342.

[1954] See also the Opinion of Advocate-General Mengozzi in C-379/05, *Amurta*, § 87: *"In order to neutralise the effects of the Netherlands legislation in question, which […] discriminates against non-residents, the relevant DTC would have to provide for an allocation of the power of taxation between the contracting parties that eliminated the disadvantage suffered by non-residents with regard to withholding tax levied on them in the Netherlands. This would be possible only if the effects of the withholding tax were entirely eliminated in Portugal, in other words by means of the full offsetting of the Netherlands withholding tax on dividends against corporation tax otherwise payable in Portugal on those dividends. Technically, this would be a 'full tax credit' that the country of residence of the taxpayer concerned […] would grant to offset the withholding tax on dividends charged by the source State"*.

[1955] Obviously, the disadvantage will not be entirely removed by a full credit either: the non-resident is still at a disadvantage if withholding tax is levied at source and subsequently refunded, as compared to the situation of a resident where no withholding tax is levied. Nevertheless, the Court seems to accept these differences in treatment as unavoidable (see also supra, on *Scorpio*: the withholding tax was compatible with the Treaty freedoms if the recipient did not produce a certificate issued by the competent tax authorities). In fact, such unavoidable disadvantages can be seen as a deviation to the Court's traditional position that any disadvantage, even minor, is sufficient to infringe the free movement provisions. See also supra, 2.E.I.B.b.1 (on *FII*) and M. LANG, "ECJ case law on cross-border dividend taxation – Recent developments", *EC Tax Review* 2008, 71.

> source State itself, which is required to remedy the discriminatory distinction. That result is in line with the approach taken by the EFTA Court in *Fokus Bank*, where the possibility to rely on tax treaty provisions to compensate for the disadvantage was entirely dismissed. The EFTA Court therefore decided that the source State is always required to remove the discriminatory distinction it introduced, regardless of the effect of tax treaty provisions[1956].

The Court has not yet clarified the reason for its distinction between offsetting advantages depending on whether they are provided for unilaterally or included in a bilateral instrument. Most likely, bilateral measures are favoured precisely because of their bilateral nature, i.e. because of the obligation they impose on the Member States involved and the resulting degree of legal certainty for the taxpayer[1957]. As will be pointed out in 2.E.I.B.g, the Court also attaches significant importance to legal certainty in the context of procedural remedies to remove the disadvantage.

As a result of this distinction, the Court generally does not take account of the legal situation in another Member State when assessing whether national tax law infringes the free movement provisions. This approach is often referred to as the 'per-country approach', which can be contrasted with the so-called 'overall approach'. Under the overall approach, the overall position of the taxpayer is taken into consideration, in both of the Member States involved (e.g. both in the source State of dividends and in the taxpayer's residence State). From the overview given above, it is clear that the Court is very reluctant to take an overall

---

[1956] EFTA E-1/04, *Fokus Bank ASA v Norway*, 23 November 2004, § 37-38: *"As a general rule, and supposing that tax advantages do in fact exist, unfavourable tax treatment contrary to a fundamental freedom cannot be justified by the existence of such tax advantages […]. A Contracting Party cannot shift its obligation to comply with the EEA Agreement to another Contracting Party by relying on the latter to make good for discrimination and disadvantages caused by the former's legislation. Likewise, the principle of legal certainty would require that the granting, or not, of an imputation tax credit to a non-resident shareholder, may not depend on whether a tax credit is granted in his or her state of residence in respect of dividend payments. […] Article 40 EEA precludes legislation whereby shareholders resident in a specific Contracting Party are granted a tax credit on dividends paid by a company resident in that Contracting Party, whereas non-resident shareholders are not granted such a tax credit. Whether the taxpayer is resident in another Contracting Party which, in a tax agreement with the Contracting Party upon the territory of which the dividend is distributed, has undertaken to grant credit for withholding tax, or whether the taxpayer in the specific case actually is granted, or will be granted, credit for the withholding tax, is of no legal significance."* See also D. WEBER, "Comments on Commission v Italy", *Highlights and Insights* 2010, 2, 52.

[1957] See also the Opinion of Advocate-General Mengozzi in C-379/05, *Amurta*, § 78, where he confirms that the disadvantage caused by the national legislation at issue cannot be removed by unilateral measures in the other Member State: *"To accept the contrary would, in essence, be tantamount to allowing a Member State to avoid its obligations under Community law by making compliance dependent on the possible effects of the national legislation of another Member State,* ***which may be amended unilaterally at any time by that State****. In such a situation* ***there would be no legal certainty*** *that a Member State would comply with the prohibition on arbitrary discrimination laid down in Articles 56 EC and 58 EC"* (emphasis added). That lack of legal certainty is absent in the case of bilateral instruments under which Member States assume *"reciprocal commitments based on a binding act"*. The binding nature of the act *"avoids creating legal uncertainty as to the Member States' compliance with their Community obligations while according due relevance to their power, in the absence of harmonisation at Community level, to establish as they see fit the criteria for allocating fiscal jurisdiction with a view to eliminating double taxation."* It is interesting to note that the Advocate-General refers to the 'reciprocal' nature of the obligations assumed under the tax treaty. As pointed out earlier, a Member State cannot rely on a bilateral instrument in order to establish that the disadvantage is removed, if the failure of one party to comply with its obligations under that instrument would absolve the other party of its own obligations. Such an interdependence of obligations can be referred to as a 'strict type' of reciprocity. The 'reciprocal' commitments referred to here should not be seen as entailing such strict reciprocity: in this context, that term is merely used to illustrate that obligations are imposed on both parties, and that the resulting balance between the parties' obligations underlies the tax treaty as a whole.

approach as regards the disadvantage-test: the Court is only willing to take account of offsetting advantages granted in another Member State if the disadvantage is effectively removed in the full amount in every situation, without the removal of the disadvantage depending on the unilateral actions of a Member State (which implies that the offsetting measure must be laid down in a binding bilateral or multilateral legal instrument).

The overall approach is sometimes referred to as the 'internal market approach'[1958], but that term may be misleading. In particular, the term internal market approach gives the impression that the overall approach is beneficial to the advancement of the internal market and should therefore be favoured over the per-country approach. The idea underlying that argument is that the overall approach succeeds in removing a number of disadvantages to cross-border transactions which the per-country approach would be unable to remedy. Yet, the case law discussed here demonstrates that it is impossible for the Court to fully opt for either the per-country approach or the overall approach in the disadvantage-test. Indeed, the nuanced approach taken by the Court is the only approach possible under the Treaty freedoms as the law stands at present. Given the importance of the non-discrimination aspect in the fundamental freedoms (see 2.D.V), advantages granted in another Member State can only be taken into account if the conditions set out by the Court are fulfilled: the disadvantage must be effectively removed in the full amount in every situation, without that removal being dependent on the unilateral actions of a Member State. If not, the disadvantage is not entirely removed, with the result that the discrimination remains.

So because this issue is entirely determined by the facts of the case and by the manner in which the Member State concerned brings forward its arguments, the Court cannot simply choose either approach. Instead, it is necessary in each case to determine whether those conditions are met in order to verify whether the disadvantage is removed. In many cases, that will obviously require a factual assessment with the result that the matter is referred back to the national court. Put briefly, the Court is unable to choose, as a matter of policy, whether one approach should be favoured over the other: the very essence of the fundamental freedoms requires a nuanced approach, with very strict conditions in order for offsetting advantages to be taken into account[1959]. Therefore, while it is true that an overall approach will be more favourable to the development of the internal market in certain instances, that does not mean that the ECJ should overstep the boundaries provided for in the EU Treaty. When applying the Treaty freedoms to national direct tax legislation, the Court will generally apply its non-discrimination analysis, with the result that offsetting advantages can only be taken into account if they effectively remove the disadvantage in a way that offers taxpayers a sufficient degree of legal certainty.

g. Procedural remedies to remove the disadvantage

The preceding sections all concern situations where a Member State defends its national legislation by denying that there is a disadvantage, either by pointing out that it is negligible or can easily be avoided, or by arguing that the disadvantage disappears because it is counterbalanced by a corresponding advantage. It is also possible, however, for a Member

[1958] E.g. E. KEMMEREN, "The internal market approach should prevail over the single country approach", in L. HINNEKENS and P. HINNEKENS (eds.), *A vision of taxes within and outside European borders. Festschrift in honor of Prof. Dr. Frans Vanistendael*, Kluwer Law International, Alphen aan den Rijn, 2008, 555-586.
[1959] See also M. LANG, "ECJ case law on cross-border dividend taxation – Recent developments", *EC Tax Review* 2008, 72, who argues that the overall approach is not a positive step towards achieving a single market because such an approach would mean that the ECJ takes over the role of the European legislator.

State to recognize that its legislation creates a disadvantage for the protected category of taxpayers, but that those taxpayers are entitled to a procedural remedy for that disadvantage.

1. Biehl and Biehl II

Such an argument was raised by the Luxembourg government in Biehl, the facts of which were discussed in 2.E.I.A.b.2.a: the Luxembourg government pointed out that there was a non-contentious procedure in Luxembourg that allowed temporarily resident taxpayer to obtain repayment of an overdeduction.

However, the ECJ rejected this argument because it was not established that there was a legal obligation on the Luxembourg tax authorities to remedy in every case the discriminatory consequences arising from the application of the measure at issue[1960]. The Advocate-General had also dismissed this argument, but on seemingly different grounds. The Advocate-General observed that, even if such a procedure ultimately enabled individuals to obtain repayment of tax overpaid in every case, it did not remove the uncertainty created by the Luxembourg tax provision at issue. According to the Advocate-General, mere administrative practices such as a non-contentious appeal, which by their nature are alterable at will by the authorities and are not given the appropriate publicity, cannot be regarded as constituting the proper fulfilment of obligations under the Treaty[1961].

At first sight, the Court's position seems to differ from that of the Advocate-General, in that the Court apparently suggests that a procedural remedy may remove the disadvantage if that remedy is imposed on the national tax authorities as a legal obligation. In contrast, the Advocate-General seems less liberal in his appreciation of the procedural guarantee because it cannot remove the uncertainty created by the discriminatory measure. Ultimately, however, both positions are quite similar. Both the Court and the Advocate-General point out that the non-contentious procedure referred to by the Luxembourg government offers insufficient legal certainty. The Court additionally suggests (a contrario) that the situation might be different if the procedure were established as a legal obligation for the tax authorities. But that idea is also implicit in the Advocate-General's position, where he points out that the non-contentious procedure is alterable at will by the authorities and not given the appropriate publicity. Neither the Court, nor the Advocate-General entirely dismiss the idea that a procedural remedy might remove the disadvantage. Instead, both suggest that such a procedural remedy could be sufficient if it offered the legal certainty that the taxpayer would be relieved from the discriminatory taxation.

That position was also taken in the subsequent *Biehl II* judgment, where the Luxembourg government once again referred to the non-contentious procedure provided for under Luxembourg law under which non-residents could obtain a repayment of tax overpaid. Once again, the ECJ rejected dismissed this argument, referring to settled case law that the incompatibility of provisions of national law with the free movement provisions can be definitively eliminated only by means of binding domestic provisions having the same legal force as the incompatible provisions at issue. Therefore, "*mere administrative practices, which by their nature are alterable at will by the authorities and are not given appropriate publicity, cannot be regarded as constituting the proper fulfilment of a Member State's obligations under the Treaty, since they maintain, for the persons concerned,a state of*

[1960] C-175/88, *Biehl*, § 17-18.
[1961] Opinion of Advocate-General Darmon in C-175/88, *Biehl*, § 18-19.

uncertainty as regards the extent of their rights as guaranteed by the Treaty". In the present case, the Luxembourg government had neither amended the contentious provisions, nor demonstrated the existence of *"a clear and specific national provisions conferring on temporary residents […] entitlement to repayment of excess amounts of tax"*[1962].

2. Schumacker

The same position was taken in *Schumacker*. As pointed out in 2.E.I.A.b.1.a, the ECJ held that the inapplicability to non-residents of the annual adjustment of deductions at source in respect of wage tax and the assessment of the tax payable on remuneration from employment constituted discrimination. Because the wage tax deducted at source was deemed to discharge all liability to income tax on remuneration from employment, non-residents were deprived, for reasons of administrative simplification, of the possibility of relying, in the annual adjustment procedure or in connection with the assessment by the administration, on certain items forming part of the basis of assessment (such as occupational expenses) which might give rise to a partial refund of the tax deducted at source.

The German government then pointed out that German law provided for a procedure under which non-resident taxpayers could ask the tax administration to supply them with a tax certificate indicating certain reliefs to which they were entitled and which the tax administration was required to retrospectively apportion equally over the calendar year. The employer was then entitled to reimburse, with the next payment of wages, the wage tax collected up to that time if the employee provided the employer with a certificate having retroactive effect. If the employer did not exercise that right, the adjustment could be made by the tax administration after the end of the calendar year.

Similarly to *Biehl*, the Court rejected this argument because the provisions of German law concerning this procedure were not binding and because the German government did not refer *"to any provision imposing an obligation on the tax administration to remedy in all cases the discriminatory consequences of application of the provisions […] at issue"*[1963].

Furthermore, there was an equitable procedure under German law pursuant to which a non-resident could ask the tax authorities to review his situation and recalculate the taxable amount. However, the Court pointed out that it was not sufficient to meet the requirements of the free movement provisions for a non-resident to have to rely on equitable measures adopted by the tax authorities on a case-by-case basis[1964].

3. Gielen

The facts of *Gielen* were discussed in 2.E.I.A.b.2.f. As discussed there, the Court held the distinction between residents and non-residents as regards the taking into account of hours worked abroad in calculating the tax deduction to constitute discrimination. However, there was a mechanism under Dutch national tax legislation which allowed non-residents to be treated as residents for tax purposes, with the result that the disadvantage would be removed (meaning that for non-residents as well, the hours worked in another Member State could be taken into account). The Dutch government argued that the discrimination as regards the

[1962] C-151/94, *Biehl II*, § 17-19. It is remarkable that the Court in *Biehl II* uses the exact same words as the Advocate-General used in *Biehl* (see supra), while the Court in *Biehl* had used slightly different wording.
[1963] C-279/93, *Schumacker*, § 53-54.
[1964] C-279/93, *Schumacker*, § 56-57, referring to C-175/88, *Biehl*.

taking into account of hours worked abroad was neutralised by the possibility for non-residents to be taxed as if they were residents.

The ECJ dismisses that argument, pointing out that the option to be treated as a resident taxpayer provides non-residents with a choice between a discriminatory tax regime and one which is ostensibly not discriminatory. However, such a choice is not capable of remedying the discriminatory effects of the first of those two tax regimes. Indeed, if such a choice were to be recognised as having a 'neutralising' effect, the consequence would be to validate a tax regime which, in itself, remains contrary to the free movement provisions by reason of its discriminatory nature. Moreover, the Court has already held in *FII* that the fact that a national measure which contravenes the free movement provisions is optional does not mean that it is not incompatible with the Treaty freedoms. The Court therefore concludes that the choice offered to non-residents to be treated as residents does not neutralise the discrimination[1965].

Accordingly, it seems that the Court is unwilling to accept the neutralising effects of a choice offered to the subject of comparison. The Advocate-General reached the same conclusion, but he deals with this issue in more detail. There are two parts to the Advocate-General's position. First, he argues that, as a matter of principle, a right of option cannot neutralise discriminatory treatment[1966]. Subsidiarily, if the Court would accept the idea that a right of option may neutralise discriminatory treatment, the Advocate-General argues that the consequences for non-residents who exercise the right of option still result in discrimination[1967]. As pointed out above, the Court takes the first approach and holds that a right of option cannot remove discrimination[1968].

The Advocate-General first points out that the issue at hand is of particular importance in the field of taxation, where taxpayers are frequently offered a number of alternative arrangements which, in some cases, contain elements that are not necessarily advantageous. In effect, accepting that a right of choice can neutralise discrimination would mean that anyone who freely chooses to be bound by a rule is not entitled to complain about it later[1969]. The Advocate-General dismisses that idea, thereby referring to the 'widely accepted saying' that "*there is no inequality in unlawfulness*". For instance, if a tax authority makes an error and calculates that a company owes less tax than it actually does, that company's rivals may not claim discriminatory treatment and demand a similar tax assessment for that reason. Likewise, in the case at hand, where a taxpayer may choose between a lawful option and an unlawful option, that choice alone does not convert the discriminatory treatment into equal treatment. Moreover, the Advocate-General points out that the fact that the right of option is available to all self-employed taxpayers, without any additional conditions applying and without taking into account the particular features of the different categories of self-employed taxpayers *"makes it all the more difficult to regard it as having a neutralising effect"*[1970].

[1965] C-440/08, *Gielen*, 18 March 2010, § 49-54.

[1966] Opinion of Advocate-General Colomer in C-440/08, *Gielen*, 27 October 2009, § 46-54.

[1967] Opinion of Advocate-General Colomer in C-440/08, *Gielen*, 27 October 2009, § 55-71.

[1968] See C-440/08, *Gielen*, 18 March 2010, § 52: *"As the Advocate General stated, in essence, in point 52 of his Opinion, if such a choice were to be recognised as having the effect described, the consequence would be to validate a tax regime which, in itself, remains contrary to Article 49 TFEU by reason of its discriminatory nature."*

[1969] In the present case, a non-resident who chooses not to be taxed as a resident would be unable to argue later that the rules applicable to non-residents are discriminatory.

[1970] Opinion of Advocate-General Colomer in C-440/08, *Gielen*, 27 October 2009, § 46-54.

Secondly, the Advocate-General argues that, if it were accepted that a right of option can remove discrimination, the consequences of that right of option would still entail discrimination. In particular, a non-resident who chooses to be taxed as a resident in the Netherlands would incur additional administrative costs as compared to a resident: unlike a resident, such a non-resident would have to declare his total income in two Member States, meaning that he would have to ensure that his accounting rules comply with two national legal systems and pay administrative costs to two tax authorities[1971]. As a result, the right of option does not remove the discrimination between residents and non-residents[1972].

4. Conclusion

From this case law, it seems that the Court is not entirely opposed to the idea that disadvantages may be duly removed by a procedural remedy in the discriminating Member State. In order for such a claim to succeed, however, the procedure must meet strict conditions. All non-residents must be guaranteed, by means of a legislative act of the same force as the act containing the discriminatory measure, that in every single case the disadvantage will be remedied. If those conditions are met, the Court apparently considers that legal certainty is duly guaranteed for such non-residents.

At first sight, this seems less strict than the position taken by the Court in respect of counterbalancing advantages. As pointed out earlier, the Court's general position there is that a discriminatory measure should be considered in isolation, without interference from extraneous factors. As a result, counterbalancing advantages cannot remove a disadvantage suffered by the subject of comparison. As discussed here, the Court seems less absolute when it comes to procedural remedies for the disadvantage.

However, in none of the cases discussed here was the procedural remedy accepted as being sufficient. Moreover, the Court does not say that it is willing to accept such procedural remedies. It only says that the procedural remedies at issue in those cases were insufficient because they did not offer the necessary legal certainty. That does not mean that a procedural remedy that meets the criteria set out by the Court as regards legal certainty (i.e. a legislative measure with binding force on the tax authorities, etc.) will be able to remove the discrimination. Assuming that to be the case might be an incorrect a contrario reasoning.

Additionally, the Court seems to take a different approach in *Gielen*. Unlike the Advocate-General in that case[1973], the ECJ refuses to ascertain whether the procedural mechanism offered by domestic law is actually sufficient to remove the disadvantage. Instead, the Court refuses, as a matter of principle, the idea that the right of option could remove the disadvantage: "*the option to be treated as a resident taxable person provides non-resident taxable persons […] with a choice between a discriminatory tax regime and one which is ostensibly not discriminatory […] if such a choice were to be recognised as having the effect described, the consequence would be to validate a tax regime which, in itself, remains contrary to Article 49 TFEU by reason of its discriminatory nature.*"[1974] Yet, it should be stressed that *Gielen* dealt with the specific situation where the Member State in question

[1971] See also 2.D.V.C.c, on *Futura*.
[1972] Opinion of Advocate-General Colomer in C-440/08, *Gielen*, 27 October 2009, § 57-63.
[1973] Opinion of Advocate-General Colomer in C-440/08, *Gielen*, 27 October 2009, § 55-71. As pointed out above, the Advocate-General only advances that argument in subsidiary order, i.e. on the assumption that the Court would accept the argument that the right of option could, in theory, remove the disadvantage.
[1974] C-440/08, *Gielen*, 18 March 2010, § 50-52.

argued that non-residents would not be discriminated against if they exercised a right of option to be treated as a resident. In other words, the discrimination as such is not removed. Rather, an optional, non-discriminatory regime is added, parallel to the discriminatory regime. That seems to be the gist of the Court's argument: the mere fact that a discriminatory regime is optional, does not make it any less discriminatory.

Nevertheless, it must be acknowledged that most procedural remedies are optional in character. Consequently, by providing for a procedural remedy such as those at issue in *Biehl* and *Schumacker*, the Member State in question also provides non-residents with a "*with a choice between a discriminatory tax regime and one which is ostensibly not discriminatory*"; that is to say, the choice between requesting for the procedural remedy to be applied or not. So if *Gielen* is transposed to such other situations, it seems that a procedural remedy, apart from meeting the conditions set out above, must also be automatic, in that it does not leave any choice to the non-resident. If the procedure were automatically applied in all situations where discrimination arises, there would not be a discriminatory regime existing in parallel with the non-discriminatory regime. Instead, all non-residents would be automatically granted non-discriminatory treatment[1975].

That being said, a parallel could be drawn to the application of Art. 24 OECD MC. As discussed in Part II, 2.B.VI.A, the OECD MC recognizes that it may be impossible for States to apply the same formalities to nationals and foreigners[1976]. Due to the additional administrative burdens when dealing with foreigners, it might be inevitable that different formalities are imposed. Art. 24 OECD MC does not preclude this, as long as the resulting treatment is not more burdensome for foreigners. The ECJ seems to take a similar approach in the case law discussed here. Thus, the procedural differentiation between residents and non-residents, in itself, may be the inevitable result of differences between those two categories of taxpayers. However, such procedural differentiations must not result in a less favourable taxation for non-residents, unless there is a procedural remedy that meets the conditions set out above and that guarantees that the disadvantage is removed. In *Biehl*, the procedural differentiation resulted in less favourable taxation of non-residents because they were unable to obtain a refund of the excess tax withheld at source. Since the procedural remedy under national law did not meet the conditions set out by the Court, the differentiation fell foul of the Treaty. Similarly, in *Schumacker*, the procedural differentiation lead to less favourable taxation of non-residents, as they were unable to rely on certain elements of the taxable base which might give rise to a partial refund of the tax deducted at source. Once again, the procedural remedy offered by national law was insufficient to duly remove the disadvantage.

I.C. The equal treatment of incomparable situations

The cases discussed above mostly concerned a different treatment of comparable situations, but discrimination may also result from the equal treatment of incomparable situations. In Part

[1975] That does not mean that the entire domestic regime at issue is rendered inoperative. Consider, for instance, a regime for taxing non-resident sportsmen, which is only discriminatory in certain factual circumstances. The procedural remedy that removes the discrimination does not have to apply automatically to all non-resident sportsmen, but only to those non-resident sportsmen who find themselves in the factual situation where discrimination arises. For other non-resident sportsmen, the regime remains applicable because it is not discriminatory from their perspective.

[1976] Similarly, with respect to Art. 24(3): see Part II, 2.D.III.B. The statements made in the Commentary that Arts. 24(4) and 24(5) do not preclude additional information requirements could also be read against this backdrop (Comm. OECD on Art. 24, paras. 75 and 80).

I, this type of discrimination has been referred to as 'discrimination by equal treatment'. The underlying idea is that incomparability requires differentiated treatment, just as comparability requires equal treatment. The ECJ has repeatedly held that *"discrimination arises through the application of different rules to comparable situations or the application of the same rule to different situations"*[1977], but there are relatively few cases in which the latter rule is applied. An overwhelming majority of cases concerns the application of different rules to comparable situations.

The analysis of cases concerning the equal treatment of incomparable situations has the same two components as the more traditional analysis of cases involving the different treatment of comparable situations. Accordingly, such cases also require an assessment of comparability and equal treatment, but the core question in both tests is inverted: in the comparability-test, the issue is whether the situations are **incomparable** and in the disadvantage-test, the issue is whether those situations are treated **equally**. Given the similarity of these tests, one could expect the Court to apply the same analysis to both types of cases. Therefore, I will assume that the comparability-test and the disadvantage-test are the same for cases concerning discrimination by equal treatment and in traditional discrimination cases, unless there are indications in the Court's case law that deviations are necessary. For that reason, I will give an overview of the Court's (scarce) case law below.

a. Comparability

1. Mertens

First of all, it is necessary to determine whether the Court applies the same comparability-test when assessing whether situations which are treated equally are incomparable as when assessing whether situations which are treated differently are comparable. A first example where the Court verified whether incomparable situations were being treated identically is *Kerckhaert-Morres*. As pointed out in 2.E.I.A.b.6.b.5, the Court held that the identical treatment of domestic dividends and foreign-sourced dividends did not constitute discrimination because the situations were not incomparable. The reasons for this incomparability were addressed in 2.E.I.A.b.6.b.5. The Court took a similar position *Columbus Container* (see 2.E.I.B.b.2). In determining comparability in those cases, the ECJ takes the same approach as in traditional cases involving the different treatment of comparable situations. In particular, the Court takes (the purpose of) the domestic measure at issue into account in order to determine the relevant characteristic. If that characteristic is identical among the subject and object of comparison, the situations are comparable. In both cases referred to here, the relevant characteristic was identical, with the result that the situations were comparable.

Another example is *Mertens*[1978], in which the ECJ was asked to consider the same Belgian regime that was at issue in *AMID* (see 2.E.I.A.b.3.a), but now from the perspective of an individual. The taxpayer was a Belgian resident who was at the same time employed in Germany and self-employed in Belgium. In the taxable year at issue, his self-employed business in Belgium suffered a loss. Under the Belgian rules described in 2.E.I.A.b.3.a, that loss was set off against the remuneration earned in Germany (and exempt in Belgium by

[1977] E.g. C-279/93, *Schumacker*, § 30; C-80/94, *Wielockx*, § 17; C-107/94, *Asscher*, § 40; C-391/97, *Gschwind*, § 22; C-311/97, *Royal Bank of Scotland*, § 26.

[1978] C-431/01, *Philippe Mertens*, 12 September 2002, *ECR* 2002, I-07073.

virtue of the provisions of the Belgian/German tax treaty). As a result, the taxpayer was unable to deduct that loss from the profit generated the next year by his self-employed business in Belgium. The ECJ was asked whether this regime was compatible with the free movement of workers.

The ECJ first recognized that the legislation at issue applied without distinction to all taxpayers who have suffered losses in respect of a self-employed activity. Indeed, the Belgian legislation provided that business losses incurred during a taxable period in respect of any business activity or employment were always deducted from income from other activities, including therefore remuneration received in respect of employment in Belgium. The Court nevertheless decided that there was discrimination because incomparable situations were treated identically. In particular, taxpayers who have exercised their right to freedom of movement and are simultaneously self-employed in Belgium and employed in another Member State, *"are not in a position comparable to that of taxpayers who carry on all their occupational activities exclusively in Belgium"*. Under tax treaties, remuneration received in respect of employment is taxable in the work State, even if the taxpayer resides in the other Contracting State. Furthermore, the loss incurred in Belgium could not be taken into account for determining taxable income in Germany, because the activity carried on in Germany was salaried. The ECJ therefore decided that the Belgian measure constituted discrimination[1979].

The Court thus holds that taxpayers who are simultaneously self-employed in Belgium and employed in another Member State cannot be compared to taxpayers who carry on all their occupational activities exclusively in Belgium. The precise reason for this incomparability is not immediately clear from the Court's reasoning. In any event, the mere exercise of the free movement of workers cannot be said to render the situations incomparable, because that would deprive the freedom of its effectiveness. Thus it seems that the actual reason for incomparability was the tax treaty, pursuant to which the remuneration is exclusively taxable in the work State. For a general overview of the influence of tax treaties on the comparability-test, see 2.E.I.A.b.9.

2. Burda[1980]

Under the German legislation at issue in *Burda*, undistributed profits were assessed to corporate income tax at a rate of 45% (tax on retentions). When profits were subsequently distributed by way of a dividend distribution, that tax rate was retroactively reduced to 30% (tax on distribution). A German resident who received dividends from a German resident company was liable to tax on dividends received, but was entitled to credit the 30% corporate income tax paid by the distributing company against its own tax liability. Non-resident recipients of dividends distributed by a German resident company were generally not entitled to such a credit.

Capital and reserves available for distribution were classified into, on the one hand, income subject to corporate tax (at 45% in the case of retention and 30% in the case of distribution) and, on the other hand, as increases in assets which were, as a rule, exempt from corporate

[1979] C-431/01, *Mertens*, § 30-32.

[1980] C-284/06, *Finanzamt Hamburg-Am Tierpark v Burda GmbH*, 26 June 2008. The part of the judgment dealing with the interpretation of the Parent-Subsidiary Directive will not be discussed here. On that aspect, see I. STAVROPOULOS, "The EC Parent-Subsidiary Directive and the decision of the European Court of Justice in Burda", *European Taxation* 2009, 150-154.

tax. The first category was referred to as EK 45, while the second was divided into four subcategories, namely EK 01 to EK 04, corresponding to different types of increases in assets. Profit distributions chargeable to increases in assets falling under subcategories EK 02 and EK 03 were subject to a tax rate of 30%. Profit distributions falling within subcategories EK 01 and EK 04 remained exempt from tax. The capital and reserves subject to corporation tax (category EK 45) were the first to be distributed, followed by those originating from additional assets, starting with subcategory EK 01.

However, if the German tax authorities established that the amount of income stated to have been used for distribution was incorrect, they proposed a correction of that amount. Such a reduction of the distributed income gave rise to a reduction in the 30% tax on distribution and, consequently, an increase in the 45% tax on retention. As a result, the distributing company owed more tax. If, in such a case, the remaining capital and reserves available for distribution in category EK 45 were not sufficient to cover the correction required by the tax authorities (and, consequently, in order to cover the profit distribution already carried out), the distribution was not charged to subcategory EK 01 but to subcategory EK 02 (by way of exception to the normal sequence for charging; see supra). As a result of that exception, the 30% rate of distribution tax was maintained after correction[1981].

The purpose of that exception was to prevent recipients of dividends from profiting from a tax credit allowed on the basis of a tax certificate issued by the distributing company, without tax having in reality been paid by that company because of the correction. In other words, the correction mechanism was intended to ensure that the amount of tax paid by the company making the distribution corresponded, after correction, to the amount of the tax credit erroneously granted to the shareholder. If, after correction, the distribution had been charged to subcategory EK 01 (which was exempt from tax even in the event of distribution), the recipients would have obtained a tax credit which was not due. For that reason, the distribution was charged to subcategory EK 02[1982]. So it is essential that the correction did not concern the amount of the tax credit but the amount of the tax paid by the distributing company.

Burda, a German resident company, distributed profits to its shareholder, a company established in the Netherlands. Because the recipient of the dividends was a non-resident, it was not entitled to a tax credit equivalent to the corporation tax paid by Burda. Following a tax audit, the German tax authorities established that Burda had distributed profits in an amount greater than the taxable income. The authorities therefore applied the correction mechanism, with the result that the tax on distribution decreased and the tax on retention increased. Moreover, the distributions no longer covered by the taxed available capital and reserves (EK 45) were charged to subcategory EK 02 (see supra).

Burda argued that this correction mechanism resulted in discrimination contrary to the free movement provisions because two incomparable situations were treated identically. In particular, the correction mechanism was intended to ensure that the tax credit was only granted to recipients of dividends if the distribution had been subject to tax in the hands of the distributing company. However, the recipient of the dividends distributed by Burda was established in the Netherlands, with the result that it was not entitled to a tax credit in Germany. Such a recipient was therefore not comparable to a resident recipient of dividends,

[1981] See supra: profit distributions charged to subcategory EK 02 were subject to a tax rate of 30%, while profit distributions charged to subcategory EK 01 were exempt from tax.
[1982] Opinion of Advocate-General Mengozzi in C-284/06, *Burda*, 31 January 2008, § 36-43.

who was entitled to a credit. Because the same correction mechanism was applied to distributions made in incomparable situations, Burda argued that it was discriminated against.

The ECJ dismissed this argument, pointing out that the correction mechanism did not alter Burda's tax burden on the basis of whether its parent company was resident in Germany or in another Member State. The Court therefore held that the correction mechanism did not cause different situations to receive identical treatment, *"since the position of the subsidiary in regard to the legislation of its Member State of residence, in this case, […] Germany, is not different according to whether it distributes its profits to a non-resident parent company or to a resident one"*.[1983]

According to the ECJ, that conclusion was not affected by the fact that, for non-resident shareholders, the tax levied on the distributing company became definitive in the sense that the increase in the tax burden imposed on the distributing company was not compensated for by the allocation of a corresponding tax credit. Referring to *ACT* (see supra, 2.E.I.A.b.6.c.1), the Court recalled that it is for each Member State to organise, in compliance with the free movement provisions, its system of dividend taxation and to define the tax base and tax rates applicable to the distributing company and/or to the recipient of the dividends, in so far as they are liable to tax in that State. Furthermore, in the absence of unifying or harmonising EU measures, Member States retain the power to define the criteria for allocating their powers of taxation, particularly with a view to eliminating double taxation. In the present case, the tax credit granted to resident parent companies was intended to prevent economic double taxation of profits distributed by a resident subsidiary which have already been taxed in the latter's hands.

However, the Court then observes that in cases concerning the cross-border distribution of profits, it is, in principle, not for the source State to prevent such economic double taxation but for the recipient's residence State. In accordance with Article 4 of the Parent/Subsidiary Directive, the latter State must either exempt from tax profits received from a subsidiary resident in another Member State or grant a credit with respect to such profits. Consequently, the parent company's residence State is required to grant fiscal treatment which is designed to achieve the same result as the tax credit which Germany grants to parent companies established there, with the effect that economic double taxation of dividends is also avoided.

Thus, just as a German resident parent company of a German resident subsidiary is granted a tax credit in Germany, the non-resident parent company of a German subsidiary is protected against the risk of economic double taxation of dividends, but by its Member State of residence. Therefore, the fact that non-resident parent companies are not entitled to a tax credit in Germany does not render the resident subsidiary of a resident parent company incomparable to the resident subsidiary of a non-resident parent company. The Court thus concludes that, for the purposes of the German correction mechanism at issue, the resident subsidiary of a resident parent company is comparable to the resident subsidiary of a non-resident parent company, with the result that there was no discrimination.

Commentary

The Court's reference to *ACT* may seem confusing. As discussed in 2.E.I.A.b.6.c.1, the Court held in *ACT* that a shareholder resident in State B who receives a dividend from a company

[1983] C-284/06, *Burda*, § 83-84.

established in State A is **not comparable** to a shareholder resident in State A who receives a dividend from a company established in State A, from the perspective of State A's legislation on the mitigation of double taxation on dividends. *Burda* concerns the comparability of a State A company distributing dividends to a State B shareholder to a State A company distributing dividends to State A shareholder, from the perspective of State A's legislation on the taxation of resident company's profits. In *Burda,* the Court held that the incomparability at the level of the recipients (see *ACT*) did not affect the comparability at the level of the distributing companies. So at first sight, the Court's position in *ACT* does not seem to support its conclusion in *Burda*.

However, the Court's reference to *ACT* should be read in its appropriate context: that reference only served to reject the argument that the situations in *Burda* were incomparable because a non-resident recipient of dividends was not entitled to a tax credit while a resident recipient was[1984]. The Court dismisses that argument by recalling its *ACT*-argument that it is generally up to the shareholder's Member State of residence to alleviate double taxation on dividends[1985]. As a result, the fact that Germany did not grant a tax credit to a non-resident shareholder did not mean that a resident company distributing dividends to a non-resident shareholder was not comparable to a resident company distributing dividends to a resident shareholder.

That being said, it would have been much clearer if the Court had first confirmed that the subject of comparison (a resident company distributing dividends to a non-resident) is comparable to the object of comparison (a resident company distributing dividends to a resident) from the perspective of the domestic legislation at issue. The purpose of that legislation was to tax the distributed profits of resident companies. From the perspective of such legislation, the relevant characteristic is the distribution of profits, irrespective of whether those profits are distributed to residents or to non-residents. The grant of a tax credit at the level of the recipients of the dividends is entirely separate from that issue, so questions relating to (the susceptibility to) double taxation are irrelevant. Accordingly, the fact that resident recipients are entitled to a credit while non-resident recipients are not does not render the situations incomparable.

So it is important to keep in mind that the question before the ECJ did not concern the tax treatment of the recipients of the dividends, but that of the distributing company. More specifically, the question was not whether non-resident recipients of German-sourced dividends should also be entitled to the tax credit in Germany. If that was the question, the decisive factor would be whether Germany exercised its taxing powers as regards dividends paid to non-residents. If so, Germany would have to extend the credit to non-resident recipients (see *ACT*). But since that was not the question referred to the ECJ, the tax treatment of the recipients was not relevant for the comparison.

However, the situation was slightly more complex because of the purpose of the German rules at issue. As noted above, the correction mechanism applied by the German tax authorities meant that the distribution was not charged to subcategory EK 01 (in which case it would be exempt) but to subcategory EK 02 (in which case the 30% rate of distribution tax was maintained after correction). The reason for that exception to the normal charging rules was that the distributing company issued a certificate to the recipient, on the basis of which the

[1984] See C-284/06, *Burda,* § 85.
[1985] The underlying reason is that the source State is not comparable to the shareholders State of residence as regards the possibility to alleviate double taxation, apart from the two exceptions discussed in 2.E.I.A.b.6.c.

latter could claim a credit. If the distribution was charged to subcategory EK 01 after correction, the recipient would be able to claim a credit (on the basis of the certificate) even though the distributing company does not pay tax on the distribution. But if the recipient is not a resident, he is not entitled to a credit in Germany, with the result that the distributing company remains subject to the 30% tax even though the recipient cannot claim a credit[1986]. Clearly, the recipient's entitlement to a tax credit is a relevant characteristic from that perspective. As a result, a resident company distributing dividends to a non-resident is incomparable to a resident company distributing dividends to a resident company from the perspective of such legislation, which means that the application of an identical regime to both companies gives rise to discrimination[1987].

The question then arises whether that discrimination is justified. According to the Advocate-General, the equal treatment introduced by the German measure at issue was justified on the basis of the balanced allocation of taxing powers. In particular, Germany applied the distribution tax irrespective of the recipient's tax position because otherwise it would have to waive its right to tax income generated by economic activities on its territory (namely if a German company could distribute dividends to a non-resident and the subsequent correction would be charged to the 0% category)[1988]. However, that argument is not entirely convincing. Germany chose to differentiate the tax rate applicable to profit distributions (i.e. either 30% or 0%), depending on the category of capital and reserves to which the distributions were charged. Additionally, Germany granted a credit to resident recipients of dividends for profit distributions taxed at 30%. In order to ensure that a recipient would not get an undeserved tax credit, subsequent corrections made to the profit distribution were charged to the 30% category. But charging the distribution to the 0% category in cases where the recipient is a non-resident (and therefore not entitled to the credit) would in no way endanger Germany's right to tax profits generated on its territory. The reason why such profits remain untaxed is that Germany has chosen to exempt certain profit distributions. So Germany does not waive its right to tax profits generated on its territory when a corrected distribution to a non-resident is charged to the 0% category: it waived its right to tax those profits when it chose to differentiate the tax rate applicable to profit distributions and to exempt certain distributions.

A more plausible justification-ground would be the prevention of abuse, but it seems that the German legislation is insufficiently precise to achieve that objective. In particular, it could be said that Germany wants to ensure that a distribution of profits by a resident company is only exempt if the recipient of the dividends is not entitled to a tax credit, in Germany or elsewhere. That could be a valid argument if the 30% tax only applied if it was certain that a non-resident recipient did not, in fact, receive a tax credit in his home State. In such a case, it would be impossible to claim a double benefit (i.e. 0% distribution tax for the distributing company and a tax credit for the recipient). The fact that the non-resident recipient may not be

[1986] Obviously, that disadvantage would be removed if a non-resident recipient was also entitled to a credit in Germany but, as noted above, that was not the issue in *Burda*. Instead, the question was whether the equal treatment at the level of the distributing companies (i.e. 30% distribution tax, regardless of the recipient's entitlement to a tax credit) gave rise to discrimination.

[1987] Even though the distributing company's tax burden is the same when it distributes dividends to resident shareholders and when it distributes dividends to non-resident shareholders, it is clear that the distributing company incurs a disadvantage in the latter situation. If the shareholder is a non-resident, it is possible that he will not be entitled to a tax credit for the 30% distribution tax (whether the absence of a tax credit in the shareholder's home State is discriminatory is not at issue here, but that may come up for discussion in the justification-analysis; see infra). So a non-resident will be dissuaded from investing in a German company, which constitutes an infringement on the Germany company's free movement.

[1988] Opinion of Advocate-General Mengozzi in See C-284/06, *Burda*, 31 January 2008, § 109.

able to credit the entire 30% in his home State is not discriminatory, since the fundamental freedoms leave each Member State free to decide if and to which extent double taxation on dividends should be removed, insofar as the domestic measures to that effect are not discriminatory. However, since the German measure at issue in *Burda* applied without any distinction to all distributions to non-residents, it is not proportionate to the objective of countering abuse. In the absence of other valid justification-grounds, it would thus seem that the German measure constituted discrimination because it treated incomparable situations identically without justification.

b. The disadvantage-test

1. General

As to the disadvantage-test, the analysis seems to be the same as in traditional cases. Accordingly, for there to be an infringement, it is necessary that the equal treatment at issue is **to the detriment of** the subject of comparison. For instance, in *Mertens* (see supra), the Court held that the equal treatment introduced by the Belgian legislation at issue was *"likely to dissuade a taxpayer who is in the position of the claimant in the main proceedings from entering into or continuing with employment in another Member State"*. Moreover, as is the case in the traditional cases, the Court rejects an overall analysis of the measure at issue when deciding whether a disadvantage occurs, instead preferring an analysis of the measure in isolation: *"even if, as the Belgian Government claims, the legislation at issue in the main proceedings has, on the whole, favourable or at least neutral consequences for individuals who avail themselves of their Community freedom of establishment or movement, the fact remains that it is clearly disadvantageous to persons who find themselves in a position like Mr Mertens merely because they are employed in another Member State"*[1989].

2. Deutsche Shell

In theory, the ECJ's analysis in *Deutsche Shell* could also be seen as an example of the identical treatment of incomparable situations. At issue in that case was German legislation which made it impossible for a resident taxpayer having a PE in Italy to deduct the currency loss arising in the PE[1990]. Upon repatriation of the PE's profits to Germany, the taxpayer incurred a currency loss due to the different exchange rates of the Italian lira and Deutsche Mark on the day the start-up capital was injected and on the day the profits were repatriated. As the PE's basis of assessment in Italy was established in Italian lira, the currency loss could not be taken into consideration there. The taxpayer argued that Germany's refusal to take account of the currency loss was contrary to the freedom of establishment.

The Court noted that the German legislation at issue increased the economic risks incurred by a company established in one Member State wishing to set up a body in another Member State where the currency used is different from that of the State of origin. In addition to the normal risks associated with setting up such a body, the head office must then *"also face an additional risk of a fiscal nature where it provides start-up capital for it. […] Because it exercised its freedom of establishment Deutsche Shell suffered financial loss which was not taken into account either by the national tax authorities for the purposes of calculating the*

[1989] C-431/01, *Mertens*, § 33-35.
[1990] C-293/06, *Deutsche Shell*, 28 February 2008, discussed earlier in 2.E.I.A.b.3.a.

basis of assessment for corporation tax in Germany or with respect to the assessment for tax of its permanent establishment in Italy"[1991].

It has been suggested that, in substance, this analysis is an application of the idea that incomparable situations must be treated differently[1992]. More specifically, the Court seems to suggest that the cross-border situation, in which the taxpayer may incur a currency loss, is different from the domestic situation, in which currency losses do not occur. Given the incomparability of these situations, they must be treated differently. Since the German measure at issue treated them identically, by disallowing the deductibility in both situations, it gave rise to discrimination.

However, the Court's analysis could also be seen as referring to the different treatment of comparable situations. In particular, it could be argued that currency losses are a specific type of business expenses. Assuming that business expenses are deductible in Germany, the non-deductibility of currency losses (which can only arise in cross-border situations) constitutes different treatment of comparable situation.

In my opinion, the latter interpretation of *Deutsche Shell* is the more convincing of the two. First of all, there can never be a currency loss in a purely domestic situation, so it is impossible to construct an appropriate object of comparison under the first interpretation. That is to say, the argument goes that the subject of comparison (a resident taxpayer who has a PE in another Member State and incurs a currency loss in that PE) cannot be compared to the object of comparison (a resident taxpayer who exercises all his business activities in his State of residence) and should therefore be treated differently with respect to the deductibility of currency losses. However, the risk of currency losses is inherent in the comparative attribute (i.e. the cross-border activity) so it cannot be said that that characteristic affects the comparability of the situations.

Secondly, it is submitted that the Court's reference to the 'increased economic risks' incurred by a company that sets up a PE in another Member State where a different currency is used does not refer to a difference between subject and object of comparison which renders the situations different. Instead, this 'additional risk of a fiscal nature' refers to the disadvantage incurred by the subject of comparison: by setting up a PE in another Member State, the taxpayer faces the risk that currency losses arising in the PE may not be deductible in his State of residence. The object of comparison, a resident taxpayer who exercises all his business activities in his State of residence, does not have to face this risk. Accordingly, there is nothing in the judgment to suggest that the Court deviates from its traditional analysis, i.e. the analysis whether comparable situations are treated differently. In my opinion, *Deutsche Shell* should therefore be read as a traditional case of comparable situations being treated differently.

c. Conclusion

Even though the relevant case law is very scarce, it seems that the discrimination-analysis in situations involving the identical treatment of incomparable situations is analogous to the test applied in situations involving the different treatment of comparable situations. That is to say, the factors that determine comparability and incomparability seem to be the same and the

[1991] C-293/06, *Deutsche Shell*, § 30-31.
[1992] M. LANG, "Recent case law of the ECJ in direct taxation: trends, tensions and contradictions", *EC Tax Review* 2009, 99-100.

questions as to what constitutes a disadvantage and whether counterbalancing advantages may remove a disadvantage should also be answered in the same way.

An important point which may seem straightforward but should not be overlooked, is that the identical treatment at issue should give rise to a disadvantage for the subject of comparison. But as the Court is quite lenient in accepting the existence of a disadvantage (e.g. by accepting there to be a disadvantage where the measure at issue is *"likely to dissuade"* the taxpayer from exercising his freedoms), this issue will generally not be decisive in practice.

II. Disparities

II.A. General

The disparity-issue, and the importance of distinguishing it from discrimination, has been touched upon earlier (cf. supra, 2.D.V.C). The general idea underlying the case law discussed below seems to be that when a taxpayer experiences a disadvantage because he exercises his freedom of movement and is consequently subject to a less advantageous tax system, there is no prohibited discrimination or restriction, but a disparity (which cannot be remedied through the ECJ's case law). In other words, the mere co-existence of disparate national rules in different Member States will generally not trigger protection by the free movement provisions, but will have to be accepted as the normal situation in a European Union with a federal-type structure and a multitude of national legislators. For instance, the Treaty freedoms will not be infringed if a taxpayer falls under a net wealth tax system in the host State while his home State does not have a net wealth tax[1993].

In direct tax matters, the idea of disparities came into prominence following *Gilly* (see below)[1994]. However, the issue had already been identified in other areas of the ECJ's case law. In *Van Dam*, for instance, the Court had to rule on the compatibility with EU law of the Dutch regulations fixing fishing quotas. According to the claimant, these regulations constituted discrimination against Dutch fishermen, as the provisions applied by the other Member States in the same maritime zone were less strict. The Court disagreed, and held that *"it cannot be held contrary to the principle of non-discrimination to apply national legislation […] because other member states allegedly apply less strict rules. Inequalities of this kind, if they exist, must be eliminated by means of the consultations provided for by Annex VI to the Hague Resolution […] but they cannot be the foundation of a charge of discrimination with regard to the provisions made by a Member State which applies equally to any person under its jurisdiction, the regulations which it had adopted for fishing quotas"*[1995].

[1993] A. CORDEWENER, "The prohibitions of discrimination and restriction within the framework of the fully integrated internal market", in F. VANISTENDAEL (ed.), *EU freedoms and taxation*, Amsterdam, IBFD, 2006, 38.

[1994] A semantic clarification may be welcome here. I use the term 'disparities' as referring to the idea that certain disadvantages fall outside the scope of the Treaty freedoms because they are caused by the co-existence of the different tax systems of the Member States. The reason why these disadvantages fall outside the scope of the freedoms is that the Member States have retained the competence of defining their tax base and allocating taxing powers between them, which means that the ECJ cannot rule on these issues. The U.S. Supreme Court makes a similar distinction between (prohibited) discrimination and (permitted) disparities, see e.g. Moorman Mfg. Co. v Bair, 437 U.S. 267 (1978).

[1995] Joined cases 185/78 to 204/78, *J. Van Dam en Zonen*, 3 July 1979, § 10.

Similarly, in *Kenny* (which concerned divergent social security legislation of Member States), the Court held that *"by prohibiting every Member State from applying its law differently on the ground of nationality, […] Articles 7 and 48 are not concerned with any disparities in treatment which may result […] from divergences existing between the laws of the various Member States, so long as the latter affect all persons subject to them in accordance with objective criteria and without regard to their nationality"* [1996].

This argument has also been applied in cases of indirect taxation. For instance, in *Weigel*, the Court held that *"the Treaty offers no guarantee to a worker that transferring his activities to a Member State other than the one in which he previously resided will be neutral as regards taxation. Given the disparities in the legislation of the Member States in this area, such a transfer may be to the worker's advantage in terms of indirect taxation or not, according to circumstance. It follows that, in principle, any disadvantage, by comparison with the situation in which the worker pursued his activities prior to the transfer, is not contrary to Article 39 EC if that legislation does not place that worker at a disadvantage as compared with those who were already subject to it"*[1997].

A final example is *Perfili*, in which the ECJ had to rule on the compatibility with the Treaty freedoms of Italian legislation requiring the victim of a criminal offence who wishes to bring suit as a civil party in criminal proceedings to grant his representative a special power of attorney, where the Member State of which the victim is a national does not lay down such a formality. The Court decided that the fundamental freedoms *"are not concerned with any disparities in treatment which may result, between Member States, from differences existing between the laws of the various Member States, so long as they affect all persons subject to them in accordance with objective criteria and without regard to their nationality"*[1998].

II.B. Dislocations

It has been argued that there is a fourth type of impediment to the exercise of the fundamental freedoms, apart from discriminations, restrictions and disparities. So-called 'dislocations' are similar to disparities, in that both are caused by the interplay of different legal systems. The difference is that dislocations are caused by the fact that the tax base is created in two jurisdictions and by the resulting need to divide that tax base between the two jurisdictions (territorial fragmentation of the tax base)[1999]. When a taxpayer exercises economic activities in different States, his tax base will be fragmented over his home State and the source State(s). Each State will divide the total tax base in a domestic and a foreign-source part, with the result that the taxpayer may lose the possibility to offset losses if a loss is attributed to one jurisdiction while positive income is attributed to another jurisdiction. By contrast, if the taxpayer obtained all his income in one State, his entire tax base would be situated in the same jurisdiction, meaning that positive and negative results are automatically matched. In that context, it is consistent for a tax regime to provide that if certain income is exempt, then any corresponding losses or costs are excluded from the tax base. However, such matching rules

[1996] Case 1/78, *Patrick Christopher Kenny v Insurance Officer*, 28 June 1978, § 18.
[1997] C-387/01, *Weigel*, 29 April 2004, § 55.
[1998] C-177/94, *Perfili*, 1 February 1996, § 17.
[1999] P. WATTEL, "Corporate tax jurisdiction in the EU with respeect to branches and subsidiaries; dislocation distinguished from discrimination and disparity; a plea for territoriality", *EC Tax Review* 2003, 194-202; J. TERRA and P. WATTEL, *European Tax Law*, Deventer, Kluwer, 2005, 58. See also Opinion of Advocate-General Geelhoed in C-374/04, *ACT*, paras. 37 and 48-54.

may constitute an impediment to cross-border economic activity as compared to a purely domestic situation. The territorial fragmentation of the tax base, and the consequences thereof (especially with regard to the offsetting of losses) may dissuade taxpayers from exercising a cross-border economic activity, particularly multinational groups of companies based in small home markets and frontier workers (both having a small home tax base).

On the other hand, it has also been argued that dislocations should not constitute a separate category of impediments[2000]. In this view, the existence of a disparity does not depend on differences in the tax systems, but solely on the interplay of the tax systems. In other words, even if two tax systems are identical in all respects, there may nevertheless be a disparity (i.e. an allowable disadvantage) where the two tax systems are applied alongside one another. Consequently, 'dislocations' also fall within the category of allowable disparities. For example, if two Member States decide to tax both non-residents and residents on their worldwide income, the double taxation arising as a result would be the consequence of an (allowable) disparity. If two Member States decide to tax non-residents and residents on domestic income only (territorial taxation), non-utilization of losses may occur in cross-border situations[2001]. Both from the point of view of the source State and from the point of view of the residence State, the disadvantage arises as a result of the interplay of two States' legislations. Both tax systems are structured in a way which renders it impossible to set off losses incurred in one State against profits arising in another State. As the disadvantage is due to the interplay of two tax systems (and, consequently, neither Member State is to blame), the authors opposing the existence dislocations as a separate category argue that this is a case of an allowable disparity.

For the purpose of the present study, this discussion is of little relevance. Neither disparities, nor dislocations fall within the scope of the fundamental freedoms. Both concepts are expressions of the ECJ's acceptance of the Member States' sovereignty in direct tax matters. Since none of the Member States concerned is 'to blame' for the disadvantage incurred by the taxpayer, the non-discrimination rule cannot be applied. Disadvantages that are caused by the interplay of different legal systems go beyond the jurisdiction of the ECJ. For that reason, I will disregard this distinction in the remainder of the study.

II.C. Case law

a. Gilly

The facts of the *Gilly*-case were set out in 2.E.I.A.b.1.a.4. Apart from the issue relating to the taking into account of personal and family circumstances, two other issues arose. First, the ECJ was asked whether the free movement of workers had been violated by the division of taxing powers pursuant to Art. 14(1) of the applicable tax treaty[2002]. In this regard, the ECJ

[2000] D. WEBER, "In search of a (new) equilibrium between tax sovereignty and the freedom of movement within the EC", *Intertax* 2006, 588; S. DOUMA, "The three Ds of direct tax jurisdiction: disparity, discrimination and double taxation", *European Taxation* 2006, 532.

[2001] Losses in the source State cannot be set off against positive income in that State (with the possible exception of loss carry-forward or carry-back). Neither can those losses be used in the State of residence, as that State only considers profits and losses in its own territory.

[2002] Three separate issues were identified in this respect: whether it was discriminatory to distinguish between frontier workers depending on whether they worked in the private sector or the public sector, whether it was discriminatory to distinguish between frontier workers in the public sector depending on whether or not they noted that *"whilst abolition of double taxation within the Community is […] one of the objectives of the Treaty, […] no unifying or harmonising measure for the elimination of double taxation has yet been adopted at Community level, nor have the Member States yet concluded any multilateral convention to that effect under Article 220 of the Treaty"*.

Consequently, the Member States remain competent to determine the criteria for taxation on income and wealth with a view to eliminating double taxation - by means, inter alia, of international agreements - and have concluded many bilateral conventions based, in particular, on the OECD MC[2003]. In the case at hand, the French/German tax treaty applied a number of connecting factors for the purpose of allocating jurisdiction between the two States as to the taxation of employment income. As a general rule under that treaty, workers were taxed in the State of employment, but frontier workers were taxed in their State of residence. Taxpayers employed in the public service were taxed in the paying State, unless they had the nationality of the work State without being at the same time a national of the paying State. In that case, the remuneration was taxable in the taxpayer's State of residence. Finally, there was a special rule for teachers habitually resident in one of the Contracting States who, in the course of a short period of residence in the other Contracting State not exceeding two years, received remuneration for teaching in the latter State. Taxpayers in that category were taxed in the State of original employment.

So the tax treaty provided for different connecting factors depending on whether the taxpayer was a frontier worker or not, was a teacher in short-term residence or not, or was employed in the private or the public sector. Taxpayers employed in the public sector were in principle taxed in the paying State unless they had the nationality of the other Contracting State without being at the same time nationals of the paying State, in which case they were taxed in their State of residence.

The ECJ held that, although the tax treaty used the criterion of nationality, *"such differentiation cannot be regarded as constituting discrimination prohibited under [the free movement of workers]. It flows, in the absence of any unifying or harmonising measures adopted in the Community context under, in particular, the second indent of Article 220 of the Treaty, from the contracting parties' competence to define the criteria for allocating their powers of taxation as between themselves, with a view to eliminating double taxation. Nor, in the allocation of fiscal jurisdiction, is it unreasonable for the Member States to base their agreements on international practice and the model convention drawn up by the OECD"*[2004].

Furthermore, even if the second sentence of Art. 14(1) of the tax treaty (which differentiated on the basis of nationality) were to be ignored, Mrs Gilly's position would remain unchanged, because her income earned in Germany would still be taxable in the paying State (Germany). Finally, the Court considered that it was not established that the choice of the paying State as the State competent to tax income earned in the public sector can of itself be to the disadvantage of the taxpayers concerned: *"whether the tax treatment of the taxpayers*

---

only had the nationality of the work State, and whether it was discriminatory to distinguish between teachers depending on the duration of their teaching activity.

[2003] C-336/96, *Gilly*, § 23-24.

[2004] C-336/96, *Gilly*, § 25-31. A similar position was taken with respect to inheritance taxes in C-513/03, *Van Hilten*, 23 February 2006, § 47-48: distinguishing on the basis of nationality for the purpose of allocating taxing powers does not come within the scope of the fundamental freedoms since such a distinction flows, in the absence of unifying or harmonising EU measures, from the Member States' power to define the criteria for allocating their taxing powers. Moreover, it is not unreasonable in this field to find inspiration in the OECD MC on Inheritances and Gifts.

concerned is favourable or unfavourable is determined not, strictly speaking, by the choice of the connecting factor but by the level of taxation in the competent State, in the absence of any Community harmonisation of scales of direct taxation". As a result, the differentiations made in the tax treaty did not fall foul of the free movement of workers[2005].

The second issue concerned the compatibility of the credit system (which was described in 2.E.I.A.b.1.a.4) with the free movement of workers. The ECJ noted in this respect that the purpose of the credit mechanism was to avoid double taxation of French residents receiving German income. Mrs Gilly argued that the mechanism penalised taxpayers exercising their treaty freedoms, as it allowed a degree of double taxation to remain. In Mrs Gilly's case, the greater degree of progressivity of the German tax scale as compared with the French tax scale caused a portion of the employment income to be taxed twice. Moreover, because Mrs Gilly's personal and family circumstances were not taken into account in Germany, whereas they were taken into account in France when calculating the tax on the total income, the tax credit accorded in France was lower than the amount of tax actually paid in Germany (this aspect was discussed in 2.E.I.A.b.1.a.4). Consequently, Mrs Gilly submitted that double taxation could only be fully avoided by granting a tax credit equal to the amont of tax charged in Germany.

However, the ECJ points out that the object of a tax treaty is simply to prevent the same income from being taxed in each of the two States. Its purpose is not to ensure that the tax to which the taxpayer is subject in one State is not higher than that to which he would be subject in the other State. Any unfavourable consequences caused by the tax treaty credit mechanism, as implemented in the tax system of the State of residence (France), are the result in the first place of the differences between the tax scales of the Member States concerned. In the absence of any EU legislation in this area, the determination of those scales is a matter for the Member States. Furthermore, the ECJ considers that, if the State of residence were required to accord a tax credit greater than the fraction of its national tax corresponding to the income from abroad, it would have to reduce its tax in respect of the remaining income, which would entail a loss of tax revenue for it and would thus encroach on its sovereignty in matters of direct taxation. As a result, the credit mechanism did not infringe the free movement of workers[2006].

To summarize, the measure was not incompatible with the free movement provisions for two (related) reasons. First, the disadvantage was due to a disparity (in other words: by working in another State, workers should accept that they may be subject to a higher tax rate). Secondly, the tax sovereignty of Member States would be breached if the ECJ were to reach the opposite conclusion. As the disadvantage was caused by the interaction of two tax systems, the ECJ would be forced to decide which Member State's taxing rights should take priority. In doing so, the ECJ would make choices that belong exclusively to the Member States' sovereignty. The only way to remove such disadvantages, is through coordination or harmonization.

[2005] Strictly speaking, this first issue was not a disparity as it has been defined above. Here, the issue was that Member States used a connecting factor based on nationality when allocating taxing powers between themselves. Because of their sovereignty in direct tax matters, the choice of such connecting factors cannot be considered to infringe the fundamental freedoms, even if they are based on nationality. The second issue in *Gilly* (which will be discussed hereafter) was an actual example of a disparity. The Member State involved did not make any prohibited distinction but the cross-border situation nevertheless faced a disadvantage because of the interplay between the different tax regimes involved. Because both issues have the same result (the fundamental freedoms do not apply, with the result that the non-discrimination analysis cannot be applied) they are discussed together.
[2006] C-336/96, *Gilly*, § 41-48.

b. Saint Gobain

The *Saint Gobain* judgment (and its implications for the comparability of PEs has been discussed in 2.E.1.A.a.1.e. However, the judgment requires some additional observations as regards the allocation of taxing powers. As mentioned before, two relief mechanisms were at play in the *Saint Gobain* case. On the one hand, the credit provided for in German domestic law as regards the Italian and Austrian dividends and, on the other hand, the exemption provided for in the tax treaties with Switzerland and the U.S. for the dividends arising in those countries. As to the former type of relief, the Court's decision is not surprising. Moreover, it is entirely in line with the practice under Art. 24(3) OECD MC. As discussed in Part II, 2.D.III.B.e, Art. 24(3) requires the PE State to extend its domestic measures for relief from double taxation to the PE which a resident of the other Contracting State has in its territory.

However, Art. 24(3) does not offer a solution where the relief mechanism is laid down exclusively in a tax treaty between the PE State and the source State of the income. In *Saint-Gobain*, the ECJ apparently decides that the discrimination standard under the fundamental freedoms differs from Art. 24(3) OECD MC in that it also entitles the PE to relief provided for in a tax treaty between the PE State and the source State. In the case at hand, the PE was thus entitled to the relief mechanism provided for in Germany's treaties with Switzerland and the U.S.

In this respect, the German government tried to justify the discrimination on the basis that the conclusion of bilateral treaties with a non-Member State did not come within the sphere of EU competence[2007]. As the taxation of income and profits falls within the competence of the Member States, they are free to conclude bilateral tax treaties with non-Member States. In the absence of EU harmonisation in this area, the question whether, in the case of dividends, the tax exemption for international groups should be granted to PEs under a tax treaty concluded with a non-Member country is not governed by the free movement provisions.

The ECJ rejected this argument. The Court first repeated its standard formula that in the absence of unifying or harmonising EU measures, the Member States remain competent to determine the criteria for taxation of income and wealth with a view to eliminating double taxation by means, inter alia, of international agreements. In this context, the Member States are free, in the framework of tax treaties, to determine the connecting factors for the purposes of allocating taxing powers between themselves[2008]. However, the ECJ continues by indicating that, as far as the **exercise** of the power of taxation so allocated is concerned, the Member States nevertheless may not disregard the free movement provisions. In the case of a tax treaty concluded between a Member State and a non-Member State, the national treatment principle requires the Member State which is party to the treaty to grant to PEs of non-resident companies the advantages provided for by that treaty on the same conditions as those which apply to resident companies[2009]. The Court also notes that the balance and reciprocity of the tax treaties would not be jeopardized by a unilateral extension by Germany of the category of recipients of the tax advantage provided for by those treaties, since such an extension would not affect the rights of the non-Member States which are parties to the treaties and would not impose any new obligation on them (see also 2.E.1.A.b.9, on reciprocity).

[2007] C-307/97, *Saint Gobain*, § 54-55.
[2008] See C-336/96, *Gilly*, § 24 and 30.
[2009] C-307/97, *Saint Gobain*, § 56-59.

This line of reasoning does not fit easily within the framework of the justification-analysis. Instead, it should be a preliminary question, to be answered before addressing the actual discrimination-issue. If the German government's argument had been accepted, the ECJ would not have been able to apply the discrimination-analysis, let alone the justification-test. In other words, this is a matter of jurisdiction: the ECJ is not competent to rule on the allocation of taxing powers in a tax treaty. If a case thus concerns this issue, there is no need for further analysis. Conversely, if a case concerns the **exercise** of the taxing powers so allocated, the substantive issues should be addressed. It would therefore be more correct for the Court to take this hurdle first, before addressing the actual discrimination-issues.

This is why *Saint Gobain* should be distinguished from *Gilly*. While *Gilly* concerned the **allocation** of taxing powers (which State has the power to tax?), *Saint Gobain* concerned a post-allocation issue: when Germany **exercises** the taxing power allocated to it under the tax treaty, it must do so in accordance with the free movement provisions. And in the present case, this meant granting the treaty credit to the PE situated in Germany. In other words, the distinction between the allocation of taxing powers and the exercise of those powers determines whether the discrimination-test can be applied. If a case concerns an allocation-issue, it falls outside the scope of the Treaty freedoms with the result that the discrimination-test does not come into play. Conversely, if a case concerns the exercise of taxing powers, the discrimination-test applies to its full extent[2010].

> As discussed earlier, in situations where the Treaty freedoms apply, they set aside discriminatory treatment by the Member States, regardless of whether this treatment results from domestic law or from a tax treaty. This prohibition of discrimination also applies if the tax treaty in question is between a Member State and a third country. However, the question then arises whether the third country's behaviour may violate this prohibition. Obviously, the EU Treaty only imposes obligations on the Member State, but it could be argued that the requirement under Art. 4(3) TEU (former Art. 10 EC) to *"take any appropriate measure, general or particular, to ensure fulfilment of the obligations arising out of the Treaties"* and to *"refrain from any measure which could jeopardise the attainment of the Union's objectives"* does not only refer to actions on the part of the Member State but also to the third country's behaviour. In particular, it could be said that the Member State is also responsible where the (non-) fulfilment of the Treaty objectives depends on an action of the third State.
>
> From this perspective, different situations can be discerned. (1) First, the situation is clear where the tax treaty obliges or allows the Member State to do something which it is not allowed to do under the fundamental freedoms. Given the priority of EU law over the tax treaty, the Member State must refrain from the action obliged or allowed under the tax treaty. (2) The same is true where the tax treaty forbids the Member State to do something (or where the tax treaty allows the Member State to refuse something) which it is obliged to do (or which it is not allowed to refuse) under the fundamental freedoms. (3) However, where the tax treaty obliges the Member State to do something which it is not obliged to do under the fundamental freedoms, or where the tax treaty forbids the Member State to do something which it is allowed to do under the fundamental freedoms, there is no incompatibility with the fundamental freedoms. By fulfilling its obligations under the tax treaty in these cases, the Member State does not violate its obligations under EU law.

[2010] If that is the case, it should be reiterated, as discussed earlier, that the presence of a tax treaty might affect both the comparability-test (see 2.E.I.A.b.9) and the disadvantage-test (2.E.I.B.e).

> Those were all examples where the tax treaty required or allowed the Member State to do something or to refrain from doing something. The situation is slightly different where it is the third country that is acting in accordance with the tax treaty. (1) The first situation is where the tax treaty obliges or allows the third country to do something which a Member State would not be allowed to do under the fundamental freedoms because it restricts a taxpayer from a Member State from enjoying his EU rights and freedoms. If one accepts that the obligation imposed on Member States by Art. 4(3) TEU includes the obligation to ensure that the third country's behaviour does not jeopardise the attainment of the EU Treaties' objectives, then the Member State must take the necessary steps to make sure that the third country refrains from the action obliged or allowed under the treaty (e.g. renegotiating the tax treaty[2011]). (2) The same is true where the tax treaty forbids the third country to do something (or where the tax treaty allows the third country to refuse something) which the Member State would be obliged to to (or which it would not be allowed to refuse) under the fundamental freedoms because it restricts a taxpayer from a Member State from enjoying his EU rights and freedoms. (3) However, where the tax treaty obliges the third country to do something which the Member State would not be obliged to do under the fundamental freedoms, or where the tax treaty forbids the third country to do something which the Member State would be allowed to do under the fundamental freedoms, there is no incompatibility with the fundamental freedoms[2012].

As a side-note, attention should be drawn to the wording of the relief provisions in Germany's treaties with Switzerland and the U.S. At first sight, the ECJ's judgment seems to imply that relief mechanisms provided for in a tax treaty between the PE State and the source State should always be extended to the PE of a company resident in another Member State. However, the relief mechanism with regard to the U.S. dividends depended on a unilateral extension by the PE State. A German resident company in the situation of the PE (i.e. holding 10.2% of the shares in the U.S. company) would not have been entitled to relief under the German/U.S treaty. Instead, the resident would have to rely on the unilateral extension of the relief (to include residents holding between 10% and 25% of the shares)[2013]. Consequently, the ECJ's decision in this respect was not a matter of extending treaty relief to the PE, as the relief to which a resident would have been entitled resulted from German domestic law. The situation was different with respect to the Swiss dividends: the exemption provided for in the treaty with Switzerland depended on the availability of a credit under domestic law. That is not really a unilateral extension of the relief provided for in the treaty. Rather, the scope of the treaty relief is determined by the scope of the domestic relief. Despite this reference to domestic law, however, it is clear that the credit is granted by virtue of the treaty[2014]. The reference to domestic law only serves to define the credit's scope of application.

[2011] If the treaty is not renegotiated, the third country is free to apply the tax treaty provision (or required to apply it, where the provision takes the form of an obligation). In that case, the Member State may become liable for damages to the taxpayer who incurs the disadvantage, under the *Francovich*-conditions. For example, the third country is the source State of interest and applies an LOB-clause contained in its tax treaty with a Member State, with the result that the reduced withholding rate is denied to the beneficiary of the income residing in the Member State. Assuming that the LOB-clause is contrary to the fundamental freedoms, the Member State could then become liable for damages resulting from this breach.

[2012] See also L. HINNEKENS, "Compatibility of bilateral tax treaties with European Community law. The rules", *EC Tax Review* 1994, 4, 159-160.

[2013] See also M. LAUSTERER, "Unlawful German tax discrimination of permanent establishments comes before the European Court of Justice", *EC Tax Journal* 1998, Vol. 3, Issue 1, 35-51.

[2014] Similarly: A. MARTIN JIMENEZ, F. GARCIA PRATS and J. CALDERON CARRERO, "Triangular cases, tax treaties and EC law: the Saint-Gobain decision of the ECJ", *Bull. IBFD* 2001, 245. See also P. GANN, "The concept of an independent treaty foreign tax credit", 38 *Tax Law Review* 1 (1982), 1-78.

Unfortunately, the ECJ does not seem to take account of this nuance. In the words of the Court, the issue concerns *"a unilateral extension […] of the category of recipients in Germany of the tax advantage provided for by those treaties, in this case corporation tax relief for international groups."* Apparently, the Court assumes that the relief in question is granted solely under the applicable tax treaty.

> The Court briefly refers to the possibility that the scope of treaty relief mechanisms is extended in domestic law, but it only does so to support its argument that requiring Germany to extend the treaty relief in the present case would not upset the balance of the treaty[2015]. However, this is beside the point. A State is free to unilaterally extend benefits granted in a treaty by a provision in its domestic law. For instance, Germany extended the relief mechanism provided for in the treaty with the U.S. to include residents with a shareholding not reaching the 25% threshold. This is exactly the same as drafting a relief provision in domestic law which is completely separate from a tax treaty. As such, this does not affect the balance and reciprocity of the treaty. For instance, the extension in German domestic law of the treaty relief provision did not affect the balance and reciprocity of the treaty, regardless of whether this relief provision referred to the treaty relief provision.
>
> The situation is different where the relief provision is laid down exclusively in a tax treaty. In that case, the provision forms part of the legal framework constituting the tax treaty, which is inherently subject to the principle of reciprocity. Given this underlying principle of reciprocity, the balance of the treaty would be altered by requiring a Contracting State to extend the benefits of the provision to residents of a third State (even though no new obligations are imposed on the other Contracting State)[2016]. Domestic provisions are fundamentally different in nature from tax treaty provisions. Even though their content may be identical, a relief provision laid down in a tax treaty is part of a bilateral instrument, which has been moulded by the give-and-take procedure of the negotiation process and is, as such, inherently reciprocal.

Assuming that the Court did not take account of this nuance, the result is that the EU Treaty freedoms go far beyond the requirements of Art. 24(3) OECD MC. Even where the relief mechanism is exclusively provided for in a tax treaty, the freedom of establishment requires the PE State to grant relief to the PE of a resident of another Member State.

[2015] See C-307/97, *Saint-Gobain*, § 60: *"the German legislature has never considered that the provisions of the double-taxation treaties concluded with non-member countries precluded any unilateral renunciation by [Germany] of levies on dividends from shareholdings in foreign companies since, in […] 1993, it unilaterally extended the corporation tax concessions to permanent establishments of non-resident companies and thus ended the difference in tax treatment […]"*. See also Opinion of Advocate-General Mischo in C-307/97, *Saint-Gobain*, § 82-84: *"Those agreements do not prevent [Germany] from extending the advantages which they contain to non-resident taxpayer companies. Extending the advantages in this way does not compromise the rights of the non-member States which are parties to the agreements and does not place them under any fresh obligation. It therefore raises no problem from the aspect of balance or reciprocity. A perfect illustration of this is provided by the practice of the German legislature in relation to agreements of the type at issue in the present case. By reducing the minimum rate of the shareholding in an American subsidiary which a German company must own in order to qualify for the advantages under the relevant agreements, […] the German legislature unilaterally extended the scope of the agreement in Germany without causing any problem in its relations with the other party to the agreement. The same happened when, by means of the Standortsicherungsgesetz of 1993, the German legislature conferred on permanent establishments of companies of other Member States the international group relief provided for in the bilateral agreements. It therefore saw no difficulties resulting from the nature of the agreements which would prevent it from extending the scope of that relief in the way sought by the plaintiff."*)

[2016] See also J. OLIVER, "Entitlement of a permanent establishment to third State treaty benefits", *B.T.R.* 2000, 179-180.

The question then arises what happens when the rate of withholding tax in the treaty between the PE State (PE) and the source State (Y) differs from the rate of withholding tax in the treaty between the source State and the taxpayer's State of residence (R). In this respect, it should be stressed that the obligation resulting from the *Saint-Gobain* case law is not inspired by a desire to abolish double taxation. Instead, the underlying idea is that discrimination between PEs and residents should be removed. And that prohibition of discrimination requires State PE to grant the PE the relief that is provided for in the treaty PE/Y, i.e. the relief to which residents of State PE are entitled.

For that reason, the extent of the obligation imposed on State PE by the non-discrimination principle depends on the wording of the relief provision in the treaty PE/Y. As pointed out above, that obligation implies that the PE is entitled to the treatment accorded to residents of State PE. And residents of State PE are entitled to relief under treaty PE/Y. So if that treaty provides, in accordance with Art. 23(B)(1)(a) OECD MC, for a credit equal to the amount of tax **paid** in the source State, then the PE will only be entitled to the tax **actually withheld** in the source State[2017] [2018]. Because the relief provision in treaty PE/Y ensures that residents of State PE are given a credit for the tax actually paid in State Y, that same treatment should be accorded to PEs in State PE. The fact that State Y is entitled to levy withholding tax at a higher rate under treaty PE/Y than under treaty R/Y does not alter the scope of relief offered to residents of State PE (and, because of the fundamental freedoms, to PEs in State PE) in treaty PE/Y.

This issue can be clarified by referring to the appropriate object of comparison. The subject of comparison, a resident of State R earning income from State Y through its PE in State PE, is compared to a resident of State PE earning income from State Y. Being a resident of State PE, the object of comparison is covered by the treaty PE/Y. And the difference in treatment at issue is precisely that the object of comparison is entitled to relief under that treaty, while the subject of comparison is not. So in order to ensure non-discriminatory treatment of PEs as compared to residents, State PE should extend the relief granted under treaty PE/Y to PEs located in its territory. If that treaty relief is limited to the tax paid in State Y (in accordance

[2017] See H. KOSTENSE, "The Saint-Gobain case and the application of tax treaties. Evolution or revolution?", *EC Tax Review* 2000, 4, 225. *Contra*: E. KEMMEREN, "Verdragsvoordelen niet alleen meer voor inwoners maar ook voor vaste inrichtingen", *WFR* 1999/6361, 1435, who argues that *Saint-Gobain* implies that the PE State is always required to provide relief in accordance with treaty PE/Y (even if the withholding rate under treaty R/Y is lower) because that is the relief to which residents of State PE are entitled.

[2018] This solution is comparable to the solution suggested in Comm. OECD on Art. 24, para. 70. As discussed in Part II, 2.D.III.B.e, the Commentary suggests that the Contracting States add a sentence to Art. 24(3) of the relevant treaty, in order to allow the PE State to credit the tax liability in the source State to an amount that does not exceed the amount that residents of the PE State can claim on the basis of the treaty PE/Y. In other words, the lowest of the rates provided for under the treaties PE/Y and R/Y is credited in the PE State. However, it should be stressed that this solution only applies where an express provision to that effect has been included in the treaty R/PE. If the PE non-discrimination clause of that treaty does not say anything about relief from double taxation provided for in tax treaties, then the PE is not entitled to such relief (see the discussion in Part II, 2.D.III.B.e). If the treaty R/PE states that PEs are entitled to relief from double taxation provided for in tax treaties in the same way as residents, then the extent of the relief depends on the wording of the treaty PE/Y. If that treaty requires State PE to grant relief for the tax actually paid at source, then it seems that State PE is required to grant a credit to the PE for the amount of tax withheld at source, even if that amount exceeds the withholding rate provided for in the treaty PE/Y. On the other hand, if the treaty PE/Y expressly limits the amount of credit State PE is required to grant to its residents to a fixed amount, then the PE is only entitled to this fixed credit under the PE non-discrimination clause of the treaty R/PE. Finally, as mentioned earlier, if the treaty R/PE contains the clause proposed in Comm. OECD on Art. 24, para. 70, then State PE is only required to grant the lowest of the rates provided for under the treaties PE/Y and R/Y.

with Art. 23 OECD MC), State PE is only required to grant PEs a credit for the tax actually paid in the source State. So if the tax withheld in State Y in accordance with the provisions of treaty R/Y is **lower** than the rate provided for in treaty PE/Y, State PE is only required to give a credit for the tax actually withheld in State Y.

But what if the tax withheld in the source State in accordance with the provisions of the treaty R/Y is **higher** than the rate provided for in the treaty PE/Y? If, in such a situation, the relief provision in treaty PE/Y provides that State PE grants a credit for the tax actually paid in State Y, it seems that the non-discrimination principle requires State PE to grant the PE a credit for the amount of tax withheld under treaty R/Y, even if that exceeds the amount which could be withheld under treaty PE/Y (and, therefore, the credit which could be given to residents of State PE).

Of course, the conclusion may be different where the relief provision in treaty PE/Y deviates from the OECD MC. For instance, where the tax withheld in the source State in accordance with the provisions of treaty R/Y is lower than the rate provided for in treaty PE/Y and the relief provision in treaty PE/Y provides that residents of State PE are entitled to a fixed lump-sum credit, it is possible that the PE is entitled to relief exceeding the amount actually withheld at source[2019].

c. Schempp

The Court's decision

Following his divorce, Mr Schempp, a German national resident in Germany, paid maintenance payments to his former spouse resident in Austria. Under the German income tax legislation, maintenance payments to a former spouse were deductible from the debtor's taxable income. However, if the payment was made to a non-resident, the deductibility was subject to the condition that the recipient had his principal or habitual residence in the territory of an EU or EEA Member State and that the taxation of the maintenance payments in the hands of the recipient was proved by a certificate of the competent foreign tax authorities. No such certificate was required when the recipient was a German resident.

Mr Schempp wanted to deduct the maintenance payments made to his former spouse from his taxable income, but the German tax authorities refused him the deduction because they had not received a certificate from the Austrian tax authorities proving that his former spouse had been taxed on the payments. Mr Schempp was unable to produce such a certificate because Austrian law did not tax maintenance payments and did not allow them to be deducted. In contrast, if Mr Schempp's former spouse had been a German resident, the maintenance payments would have been deductible, even though she would not have paid any tax on the payments because her income was less than the taxable minimum in Germany. Mr Schempp argued that this difference in treatment constituted discrimination contrary to the prohibition of discrimination on the grounds of nationality (current Art. 18 TFEU, former Art. 12 EC) and the right of free movement and residence of EU citizens (current Art. 21 TFEU, former Art. 18 EC).

The ECJ first examined whether Mr Schempp's situation fell within the scope of EU law. In this respect, the ECJ recalled that Art. 18 TFEU must be read in conjunction with the Treaty

[2019] B. PEETERS, "EG-recht en overeenkomsten ter vermijding van dubbele belasting", in B. PEETERS (ed.), *Europees belastingrecht*, Brussels, Larcier, 2005, 235-236.

provisions on citizenship of the Union: "*citizenship of the Union is destined to be the fundamental status of nationals of the Member States, enabling those who find themselves in the same situation to receive the same treatment in law irrespective of their nationality, subject to such exceptions as are expressly provided for*"[2020]. Under Art. 20(1) TFEU, every person holding the nationality of a Member State is a citizen of the Union. Consequently, Mr Schempp, as a German national, is a citizen of the Union. Art. 20(2) TFEU attaches to the status of citizen of the Union the rights and duties laid down by the Treaty, including the right to rely on Article 18 TFEU in all situations falling within the material scope of EU law. Those situations include the situations involving the exercise of the fundamental freedoms guaranteed by the Treaty and those involving the exercise of the right to move and reside within the territory of the Member States, as conferred by Art. 21 TFEU.

The German government argued that Mr Schempp's situation had no link with EU law because it was purely internal to one Member State (Germany). The person relying on Art. 18 TFEU, Mr Schempp, did not exercise his right of free movement as guaranteed by Art. 21 TFEU His former spouse had exercised such a right, but the case concerned Mr Schempp's taxation, not the taxation of his former spouse. According to the German government, the only factor external to Germany was that Mr Schempp made maintenance payments to a person resident in another Member State. As maintenance payments do no affect intrastate trade, the German government argued that the situation did not fall within Art. 18 TFEU.

However, the ECJ pointed out that the situation of a national of a Member State who has not exercised his freedom of movement could not, for that reason alone, be assimilated to a purely internal situation. Under the German legislation, the deductibility of maintenance paid by a taxpayer resident in Germany to a recipient resident in another Member State depended on the fiscal treatment of those payments in the recipient's State of residence. Consequently, by exercising her right to move and reside freely in another Member State, Mr Schempp's former spouse influenced her former husband's capacity to deduct the maintenance payments from his taxable income in Germany. Therefore, the ECJ held that, "*since the exercise by Mr Schempp's former spouse of a right conferred by the Community legal order had an effect on his right to deduct in his Member State of residence, such a situation cannot be regarded as an internal situation with no connection with Community law*"[2021].

> This line of reasoning may be referred to as 'derivative discrimination'. A similar interpretation was applied in *Zurstrassen*[2022] and *Halliburton*[2023]. In the former case, the Luxembourg rules under which the joint assessment to tax of spouses was conditional on their both being resident on national territory, was found to violate the free movement of workers. Mr Zurstrassen, a Belgian national residing in Luxembourg and employed in Luxembourg, was denied this benefit because his spouse resided in Belgium, even though Mr Zurstrassen earned 98% of the family income in Luxembourg. The Court considered the measure to be discriminatory, even though the disadvantage was caused by the non-residence of the complaining taxpayer's spouse. In other words, the external factor required to render EU law applicable was not the taxpayer's exercise of his freedoms (as he resided in the Member State where he was employed) but the fact that his spouse resided in another

[2020] C-403/03, *Schempp*, 12 July 2005, § 15, referring to C-184/99, *Grzelczyk*, ECR 2001 I-6193, § 30-31, C-148/02, *Garcia Avello*, ECR 2003 I-11613, § 22-23 and C-209/03, *Bidar*, ECR 2005 I-02119, § 31.
[2021] C-403/03, *Schempp*, § 22-25.
[2022] C-87/99, 16 May 2000, *ECR* 2000, I-03337. See also R. NEWEY, "Discrimination against resident whose spouse lived in another Member State", *European Taxation* 2000, 554-557.
[2023] C-1/93, 12 April 1994, *ECR* 1994, I-01137.

> Member State. Even though the taxpayer was not being discriminated against on the basis of his residence, its derivative effect placed non-residents at a disadvantage.
>
> In *Halliburton*, a non-resident company was derivatively discriminated against in the Netherlands because its transaction partner, a company established in the Netherlands, was required to pay transfer tax on the alienation of immovable property[2024].

The ECJ then went on to examine whether Art. 18 TFEU had been violated by the refusal to deduct the payments. As mentioned earlier, the non-deductibility in Mr Schempp's situation was due to the non-taxation of the payments in Austria and the condition laid down in the German legislation that a certificate of taxation in the recipient's State of residence had to be produced. The ECJ held in this respect that *"it is apparent that the unfavourable treatment of which Mr Schempp complains in fact derives from the circumstance that the tax system applicable to maintenance payments in his former spouse's Member State of residence differs from that applied in his own Member State of residence"*[2025]. In contrast, if his former spouse had chosen to reside in a Member State in which maintenance payments are taxed, Mr Schempp would have been entitled to deduct the payments.

The ECJ continued by pointing out that Article 18 TFEU is not concerned with disparities*"which may result from divergences existing between the various Member States, so long as they affect all persons subject to them in accordance with objective criteria and without regard to their nationality"*. As a result, the payment of maintenance to a recipient resident in Germany could not be compared to the payment of maintenance to a recipient in Austria because the recipient was subject in each of those two cases, as regards taxation of the maintenance payments, to a different tax system. As a result, the German measure did not constitute discrimination within the meaning of Art. 18 TFEU[2026].

As to the argument that, Mr Schempp would have been able to deduct the payment if his former spouse had resided in Germany, even though it would not have been taxed because the former spouse's income was below the German tax threshold, the ECJ held that this did not change the conclusion. According to the ECJ, *"the non-taxation of maintenance payments on those grounds in Germany cannot be equated to the non-taxation of the maintenance in Austria on the ground of its non-taxable character in that Member State, since the fiscal consequences which attach to each of those situations as regards the taxation of income are different for the taxpayers concerned"*[2027].

The ECJ finally holds the German measure against the light of Art. 21 TFEU, concluding that the German legislation did not obstruct Mr Schempp's right to move and reside in another Member State. The transfer of his former spouse's residence to Austria entailed unfavourable consequences for Mr Schempp's in his State of residence, but the Court held that the Treaty does not guarantee a citizen of the Union that transferring his activities to a different Member

[2024] See also J. TERRA and P. WATTEL, *o.c.*, 64.
[2025] C-403/03, *Schempp*, § 32.
[2026] C-403/03, *Schempp*, § 34-36. Mr Schempp countered the ECJ's conclusion by arguing that the discrimination arose from the fact that deductibility of maintenance paid to non-residents was conditional on the recipient actually paying tax, while no such condition was stipulated if the recipient was a German resident. The ECJ side-stepped this argument by referring to the facts at issue. The ECJ was only asked to decide on the situation where a taxpayer resident in Germany was unable to deduct maintenance payments made to a resident in Austria. Consequently, the point addressed by Mr Schempp did not arise, as it concerned payments made to a resident of another Member State in which those payments were taxable, whereas maintenance payments were not taxable in Austria.
[2027] C-403/03, *Schempp*, § 39.

State will be neutral as regards taxation. Given the disparities in the tax legislation of the Member States, such a transfer may be to the taxpayer's advantage or not. According to the Court *"the same principle applies a fortiori to a situation such as that at issue in the main proceedings where the person concerned has not himself made use of his right of movement, but claims to be the victim of a difference in treatment following the transfer of his former spouse's residence to another Member State"*[2028].

Commentary
1. Two disadvantages

It is difficult to agree with the Court's conclusion that the disadvantage was due to a mere disparity. Clearly, the German legislation was not neutral as regards cross-border payments, since it imposed two additional conditions for deductibility as compared to a domestic payment: (1) those payments had to be taxable in the hands of the recipient and (2) that taxation had to be proved by a certificate of the competent authorities.

Accordingly, there are two separate disadvantages. First, the payments have to be taxed in the hands of the non-resident recipient while this is not required if the recipient is a German resident. Consequently, it is possible that the deductibility is granted if the payment is made to a German resident even though it remains untaxed in the recipient's hands (e.g. because the tax-free amount has not been exceeded) while that is impossible if the recipient is a non-resident who is not taxed on that payment. The Court first holds that the non-taxation in the other Member State is a disparity (§ 31-32 of the judgment) and then that the non-taxability in Germany where the tax-free threshold is not exceeded is not comparable to the non-taxability in another Member State that exemps maintenance payments (§ 39 of the judgment; see infra).

Secondly, even if the payments are taxed in the recipient's State of residence, German legislation required a certificate proving that taxation, while not requiring any proof where the recipient is a resident. Here, the payments were not taxed in Austria, with the result that the second condition became irrelevant. But it is nevertheless clear that Germany imposes an additional condition by requiring a certificate. Obviously, that additional requirement is not due to a disparity, with the result that the Court should have applied its traditional non-discrimination standard to this aspect. Even if the maintenance payment is taxed both in the hands of the resident recipient and in the hands of the non-resident recipient, the latter payment is treated less favourably because a certificate is required. It would be interesting to know whether the Court considers that additional requirement to be justified.

And what if the recipient is established in a Member State that taxes maintenance payments but where the same tax-free threshold applies as in Germany? In that case, Germany would deny the deduction because the taxpayer cannot provide a certificate of taxation. Would the ECJ then still decide that the non-taxation in Germany is not comparable to the non-taxation in the other Member State (see supra)? Unfortunately, the Court does not answer that question.

2. Disparity or discrimination?

As to the first requirement (that the payments have to be taxable in the hands of the recipient), the taxpayer had expressly argued that there was discrimination because Germany made the

[2028] C-403/03, *Schempp*, § 45-46.

deductibility of maintenance paid to non-residents conditional on the recipient actually paying tax, while no such condition was stipulated if the recipient was a German resident. The ECJ's response to this argument is remarkable, since it simply observes that this point did not arise because it concerned payments made to a resident of another Member State in which those payments were taxable, whereas maintenance payments were not taxable in Austria[2029]. As to the argument that, if Mr Schempp's former spouse had resided in Germany, he would have been able to deduct the payment, even though it would not have been taxed because the former spouse's income was below the German tax threshold, the ECJ held that this did not change the conclusion because *"the non-taxation of maintenance payments on those grounds in Germany cannot be equated to the non-taxation of the maintenance in Austria on the ground of its non-taxable character in that Member State, since the fiscal consequences which attach to each of those situations as regards the taxation of income are different for the taxpayers concerned"*[2030].

The Court's line of reasoning is a bit puzzling. The disadvantage was precisely caused by the fact that German law required the payments to have been taxed in the other Member State, while that requirement did not apply to payments made in Germany. That was the reason why Mr Schempp (the subject of comparison) could not deduct the payment, while he could have done so if his former spouse resided in Germany (the object of comparison). Insisting that this point does not arise *"because it concerned payments made to a resident of another Member State in which those payments were taxable"* is incorrect. The point did arise, precisely because the payments were not taxable in Austria. In other words, the point raised by Mr Schempp was not that the payment could have been deductible had it been made to a person resident in a Member State that taxed the payment, but that German legislation made the deduction conditional upon it being taxable in the State of residence of the recipient, which was not the case in Austria.

The final addition, that the non-taxation in Germany "cannot be equated to" the non-taxation in Austria, explains this somewhat convoluted line of reasoning. The taxpayer's argument compares a resident taxpayer paying maintenance to a former spouse residing in Austria and a resident taxpayer paying maintenance to a former spouse residing in Germany, with the former spouse's income in the latter situation not exceeding the German threshold. In neither of these cases would the former spouse be taxed on the maintenance payment, but the taxpayer would only be able to deduct the payment in the latter situation. The Court dismisses this argument, albeit in less-than-clear language, by deciding that the situations are incomparable. The reason for that incomparability is that "the fiscal consequences of the non-taxation" of the income are different for the taxpayers concerned in both cases. Because the situations are incomparable, there is no discrimination.

> It is not immediately clear what is meant by the statement that 'the fiscal consequences' attaching to those situations are different for the taxpayers involved. The Commission had also argued that the two situations of non-taxability could not be compared, on the grounds that *"the fiscal treatment of maintenance payments must not be seen in isolation from the way in which other sources of income are taxed and may benefit from exceptions"*[2031]. Perhaps, the Court means that the incomparability was due to the fact that the non-taxability of maintenance payments in Germany was subject to the condition of staying below the threshold, while maintenance payments

[2029] C-403/03, *Schempp*, § 38.
[2030] C-403/03, *Schempp*, § 39.
[2031] See Opinion of A.-G. Geelhoed in C-403/03, *Schempp*, § 25.

> were always exempt in Austria, irrespective of their amount. Accordingly, if the hypothetical German resident recipient of the maintenance payments received a higher amount of payments in a given year, or received other income in addition to these payments, the tax-free threshold might be exceeded with the result that tax is due on the maintenance payments. In contrast, irrespective of the amount of maintenance payments and irrespective of the existence of other sources of income, the maintenance payments are exempt in Austria. That might also explain the Commission's statement, quoted above, that the tax treatment of the maintenance payment must be seen in connection with *"the way in which other sources of income are taxed and may benefit from exceptions"*.
>
> As pointed out in 2.E.I.A.2.1.a.9, the Court tried to distinguish *D* from *Wallentin* by observing that the payments derived by Mr Wallentin in his home State *"did not of their nature constitute taxable income"* in that State. At first glance, that distinction is similar to the distinction made by the Court in *Schempp*. However, if the underlying reason for incomparability in *Schempp* was the 'conditional' nature of the exemption under the German system (i.e. the exemption being conditional on the income not exceeding the threshold) as compared to the 'absolute' nature of the exemption under the Austrian system, then this parallel does not hold. Indeed, both the exemption of the subsistence allowance and the government grant in *Wallentin* and the non-taxability of wealth in *D* were equally 'absolute'.

In other words, the Court seems to make a two-step analysis. (1) First, it decides that the issue falls outside the scope of the Treaty freedoms because the non-taxation in Austria (which causes the disadvantage) is due to a disparity. (2) The Court then nevertheless decides that no discrimination has arisen because of the lack of comparability. More specifically, Germany does not discriminate when it requires the payments to have been taxed in the other Member State because non-taxability in a Member State that exempts maintenance payments is not comparable to non-taxability in Germany in cases where the tax-free threshold is not exceeded. In other words, (1) the fact that Germany considers maintenance payments to constitute taxable income while Austria does not is a disparity. (2) But there are also situations in which Germany does not tax such payments, e.g. when the tax-free threshold is not exceeded. Does it constitute discrimination when Germany distinguishes between that situation and the situation where the recipient is established in Austria (and, therefore, not taxed on the payment because it is exempt)? According to the Court, it does not because the non-taxation in both cases is incomparable.

Put briefly, the analysis is confounded because there are two different issues at stake here. First, a taxpayer in Mr Schempp's position – i.e. a German resident paying maintenance to a resident of Austria, where such payments are exempt – is unable to deduct while the deduction is granted to a German resident paying maintenance to another German resident who is taxed on that payment. The disadvantage incurred by the former taxpayer is due to a disparity: Germany cannot be held responsible for the fact that Austria does not tax maintenance payments. Secondly, if Mr Schempp is compared to a German resident paying maintenance to another German resident who is not taxed on that payment because the tax-free threshold is not exceeded, the issue turns to discrimination. Indeed, the disadvantage can then no longer be explained by the fact that Germany taxes the income but Austria does not. Neither State taxes the income, but there is no discrimination since the non-taxation in Germany is incomparable to the non-taxation in Austria.

So there is a subtle difference between the aspect of the judgment concerned with disparity and the aspect concerned with discrimination and the distinction made by the Court in this respect is correct. As noted above, however, the Court is not very consistent in distinguishing discrimination cases from disparities. *Schempp* demonstrates that this may lead to confusing case law and that it would be preferable for the Court to be less cryptic and distinguish clearly between the different aspects of its judgments.

F. Conclusions

I. On comparability: a plea for fractional taxation

The contrast between the *Schumacker*-style cases and the *Gerritse*-style cases demonstrates the importance of the nature of the tax benefits at issue for purposes of the comparability-test. The general conclusion to be drawn from this body of case law is that residents and non-residents are comparable with respect to income-related benefits, which means that different treatment is discriminatory (cf. *Gerritse*). By contrast, residents and non-residents are generally not comparable with respect to person-related benefits (tax-free allowances, splitting of family income, deduction for maintenance payments, etc.). As a result, the source State is allowed to refuse such personal benefits to non-residents. It is up to the home State to grant these benefits because that State is in a better position to assess the taxpayer's personal situation. As a general rule, the home State is required to take full account of the taxpayer's personal and family circumstances, irrespective of the division of his income over the source State and the home State. Regardless of its share in the taxpayer's worldwide income, the home State is required to fully take account of the personal and personal circumstances (see *De Groot*). As an exception to this rule of full home State responsibility, if it is impossible for the home State to take the taxpayer's personal and family circumstances into account because his entire income is foreign-sourced, then the obligation to take account of these circumstances shifts entirely to the source State[2032]. In such a situation, the taxpayer is comparable to a resident of the source State, which means that he is entitled to the same person-related benefits (see *Schumacker*). The same rule, i.e. full source State responsibility, also applies if the non-resident taxpayer has sufficient income in his home State to absorb the personal allowances granted in the home State but that income is not taxable (see *Wallentin*).

I have argued in 2.E.I.A.b.1.c that the *Schumacker*-doctrine should be replaced by a fractional approach, under which the source State is required to grant non-resident workers a pro rata part of its person-related benefits, insofar as that State applies a pro rata system of person-related benefits to its own residents (national treatment). Such an approach squares better with the requirements of non-discrimination, since that principle does not require that benefits are granted 'always somewhere', but rather requires comparable situations to be given the same treatment. And, from the perspective of tax legislation that takes account of a taxpayer's ability to pay tax, comparability is determined by the amount of income earned in the Member State concerned.

As discussed in 2.E.I.B.g.3, the ECJ has held in *Gielen* that the choice offered to non-residents to be treated as residents does not neutralise the discrimination. Does that mean that the fractional approach is precluded, since that approach implies that non-residents are treated as if they are residents and would have to report their worldwide income both in their home

[2032] Another exception to this rule occurs where the home State is released from its responsibility under a tax treaty, or where the work State takes grants person-related benefits to non-residents of its own accord, on the condition that, ultimately, all the non-residents' personal and family circumstances have duly been taken into account (*De Groot*, § 99-101).

State and in the source State? In my opinion, the Court's position in *Gielen* does not preclude a fractional approach. First of all, *Gielen* concerned the specific situation where a Member State argued that a discriminatory measure was neutralised by a right of option granted to non-residents: since they were entitled to opt for a non-discriminatory regime, they could no longer complain about the other, discriminatory regime. The Court dismissed that argument as a matter of principle. But the Court does not reject the idea that fractional taxation might resolve issues of discrimination[2033]. Indeed, the fractional approach is not meant to be optional. Additionally, *Gielen* does not imply that the mere fact that being treated as a resident entails additional administrative burdens (in that the taxpayer should report his worldwide income in two States) is contrary to the fundamental freedoms. *Gielen* only says that making discrimination optional does not make it any less discriminatory. That is a different matter altogether.

It is true that the proposed fractional approach would mean that a non-resident has to report his worldwide income both in his home State and in his source State. Such a taxpayer would thus incur additional administrative costs as compared to a resident, who has to report his worldwide income only in his home State. Yet, it is clear that the mere fact that a taxpayer is subject to two different regulatory regimes as a result of the exercise of his Treaty freedoms does not constitute discrimination[2034]. Such a dual burden might give rise to a non-discriminatory restriction, but, in matters of direct taxation, a restriction will only infringe the Treaty freedoms in rare cases. As discussed in 2.D.V.C, a non-discriminatory restriction incurred by a taxpayer can only give rise to a violation of the fundamental freedoms in direct tax matters if the objective sought by the measure at issue can be duly ensured by means of mutual recognition, that is to say, if the aim pursued by the restrictive measure is already attained by a similar measure which applies in the taxpayer's home State. The most obvious example is the accounting rule which was discussed in *Futura*: the double burden created by the Luxembourg measure was restrictive, in that the taxpayer already kept proper accounts in his home State. Since the home State accounting rules ensured the attainment of the objective sought by the Luxembourg accounting rules, Luxembourg had to recognise those home State rules.

That approach cannot be transposed to the rules governing the reporting of worldwide income. Given their sovereignty in direct tax matters, the Member States remain free to design their tax systems as they see fit, and that includes the rules that govern which items of income should be declared and how. If, for instance, one Member State does not require its residents to declare income from immovable property while another Member State does, it is clear that the mutual recognition of the tax systems concerned does not lead to the attainment of the objectives sought by those systems. For that reason, the 'dual burden' imposed by the

---

[2033] See also Opinion of Advocate-General Colomer in C-440/08, *Gielen*, 27 October 2009, § 77-78: *"I have set out the above considerations in order to consider whether the right of option has the effect of neutralising the discrimination identified against non-residents. It is necessary to exercise great care in that regard, since the system implemented by the Netherlands has clear advantages. According to learned authorities, allowing a taxpayer to pay tax on his total income in both the State of residence and the source State is likely to give rise to an ideal outcome, particularly with regard to the transnational taxation of natural persons. Having regard to the various tax models in place in the Member States, the Netherlands system has positive elements which I do not question. Nor do the present proceedings seek to challenge the lawfulness of that system, and the dispute is confined to the question whether such a system has a neutralising effect. It is only in that regard that Article 2(5) of the Law on income tax is insufficient to justify the unlawful discrimination suffered by non-residents like Mr Gielen."*

[2034] E.g. C-403/03, *Schempp*, § 32-34. See also 2.E.II, on disparities.

fractional approach, in that the non-resident has to report his worldwide income in two Member States, cannot be said to restrict the Treaty freedoms.

That being said, the question arises which tax benefits are 'person-related' benefits, i.e. which domestic measures should be analysed under the fractional approach. As discussed in 2.E.I.A.b.1.d, all domestic measures that take account of a taxpayer's ability to pay tax should be covered by the fractional approach. However, determining whether a domestic measure relates to taxpayers' ability to pay tax is not always straightforward, as *Ritter*, *Lakebrink* and *Renneberg* illustrate (see 2.E.I.A.b.1.b)[2035]. Indeed, because ability to pay is such a wide concept, it is impossible to give an exhaustive overview of all tax measures that take account of a taxpayer's ability to pay. As a result, a factual assessment is necessary in each case in order to determine the nature of the domestic measure under scrutiny. The ECJ's case law has identified two examples of measures that take account of a taxpayer's ability to pay. First of all, tax benefits that are granted in order to take account of the taxpayer's personal and family situation (e.g. being married, having children in one's care, etc.) and secondly, tax measures that take account of a taxpayer's worldwide income (including negative income from immovable property).

II. Comparability should be distinguished from proportionality

The concept of proportional comparability has been referred to earlier, most notably in the discussion of *Truck Center,* where the Advocate-General argued that, *"for a finding of non-discrimination, it is not sufficient to point out that citizens and foreign nationals are not in the same situation. It is also necessary to demonstrate that the difference in their respective situations is capable of justifying the difference in treatment. In other words, the difference in treatment must relate and be proportionate to the difference in their respective situations"*[2036].

This seems to suggest that comparability is a matter of degree, rather than a matter of kind. In other words, rather than being comparable or incomparable, situations would be more comparable or less comparable. As a result, the idea that non-discrimination requires comparable situations to be treated equally and, conversely, incomparable situations to be treated differently, would have to be adjusted. Instead, situation A would no longer be simply comparable (or incomparable) to situation B and therefore require identical (or different) treatment. Rather, the treatment accorded to situation A would depend on its degree of comparability to situation B. The more comparable situation A is to situation B, the closer should the treatment accorded to situation A approach the treatment accorded to situation B. And if there is a third situation C that differs slightly more from situation B than situation A, then the treatment accorded to situation C should approach the treatment granted to situation B slightly less than the treatment accorded to treatment A.

Apart from being impractical, such an approach is problematic from a conceptual perspective. First of all, comparability refers to the identity of relevant characteristics. And it is clear that

[2035] Reference can also be made to Part II, 2.D.III.D, where a similar issue was discussed in the context of Art. 24(3) OECD MC. That provision does not apply to *"personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents"*, but it is difficult to determine which measures are covered by that expression.
[2036] Opinion of Advocate-General Kokott in C-282/07, *Truck Center*, § 37.

identity is not a matter of degree: either two characteristics are identical or they are not. It is pointless to say that two characteristics are 'almost' identical.

Moreover, as discussed in Part I, B.III, the principle of non-discrimination is an expression of the idea of horizontal equity. Horizontal equity means that all taxpayers with the same ability to pay should bear the same tax burden. Essentially, that is what non-discrimination tries to achieve. By preventing that taxpayers who have the same ability to pay (and are therefore comparable from the perspective of income taxes) are treated differently, non-discrimination seeks to ensure horizontal equity. Vertical equity, on the other hand, implies that a person with a higher ability to pay should bear a higher tax burden than a person with a lower ability to pay. But that is not a matter which the non-discrimination principle regulates. The principle of non-discrimination does not contain specific guidelines on how persons with higher ability to pay should be treated as compared to persons with lower ability to pay. More specifically, the only conclusion to be drawn from the non-discrimination principle in this respect is that a person with a higher ability to pay should be taxed **differently** from a person with a lower ability to pay (because incomparable situations should be treated differently). But it does not prescribe **how** they should be treated. Implementing a system of vertical equity is a matter of policy which goes beyond the framework provided for by the non-discrimination principle. Worded differently, vertical equity is not a matter for the judiciary but for the legislator.

Proportional comparability is an expression of vertical equity. As explained above, proportional comparability means that, because situation A is more comparable to situation B than situation C, the treatment accorded to situation A should approach the treatment accorded to situation B more than the treatment accorded to situation C. But that is a matter of policy. Non-discrimination does not require the treatment accorded to situation A and C respectively to be differentiated according to their degree of comparability to situation B. And since the fundamental freedoms are based on the principle of non-discrimination, there is no legal basis to include a proportional comparability-test in the ECJ's analysis[2037]. Accepting such a concept of proportional comparability would thus go beyond the non-discrimination standard as it is provided for in the fundamental freedoms.

It is therefore submitted that the comparability-test should be a binary analysis, as it is in the Court's traditional interpretation: situations are either comparable or incomparable, there is nothing in between. Proportionality should not affect the comparability-test but should remain confined to the justification-analysis. Of course, the main reason why it may be tempting to incorporate elements of proportionality in the comparability-test, is that it is often exceptionally difficult to distinguish justification-grounds from elements of comparability. The following section deals with that issue.

III. How to distinguish justification-grounds from elements of comparability

III.A. General

Throughout the discussion of the ECJ's case law, it has become clear that it is sometimes very difficult to determine whether an argument is an element of the comparability-test or

[2037] As noted in 2.E.I.A.b.1.c, the fractional approach to taxing cross-border income, which is advocated in this study, is not a matter of proportional comparability.

constitutes a justification-ground. Indeed, justification-grounds can generally also be phrased in terms of comparability, precisely because the justification relates differently to the object and subject of comparison[2038]. For instance, the need to ensure efficient administrative supervision relates differently to residents and non-residents because the former are subject to the direct supervision of the residence State's tax authorities while the latter are not. Similarly, the need to prevent that losses are taken into account twice relates differently to domestic and cross-border situations because that risk is obviously greater where different Member States are involved. Does that mean that the subject and object of comparison are thus rendered incomparable because they are in different situations with respect to administrative supervision or with respect to the risk that losses are taken into account twice?

A first point to be addressed is that, for the purpose of distinguishing between these concepts, it is not sufficient to simply consider whether an argument relates to the **purpose** of the measure at issue. It is true that justification-grounds always relate to the purpose of the measure, since justifying a discriminatory measure means demonstrating that it is necessary to restrict the fundamental freedoms in order to attain an objective of general interest. However, comparability-arguments may also relate to the purpose of the domestic measure at issue. In several cases, the ECJ has indeed expressly held that the comparability of the situations *"must be examined by taking into account the objective pursued by the national provisions at issue"*[2039]. That statement should be read against the backdrop of the fundamental idea that comparability means that all relevant characteristics, apart from the comparative attribute, must be identical. And in certain cases, it is necessary to take account of the objective of the domestic measure in order to ascertain whether a given characteristic is relevant. For instance, the susceptibility to double taxation is a relevant characteristic in the context of domestic measures intended to alleviate double taxation on dividends, given those measures' purpose of alleviating double taxation (see 2.E.I.A.b.6).

The justification grounds that have been accepted by the ECJ are the prevention of tax avoidance[2040], the risk that losses are deducted twice[2041], fiscal cohesion[2042], territoriality[2043], the balanced allocation of taxing powers[2044] and the effectiveness of fiscal supervision in situations involving a third State[2045]. Other justification grounds, such as the loss of tax revenue[2046] or the effectiveness of fiscal supervision in the intra-EU context[2047] have been dismissed by the Court.

All of these arguments could also be seen as comparability-issues. First, where a domestic measure is intended to prevent tax avoidance, it is clear that a situation falling within the scope of that measure (e.g. a cross-border payment) differs from a situation not falling within that scope (e.g. a domestic payment) with respect to a characteristic that is relevant from the

---

[2038] Similarly, R. LYAL, "Non-discrimination and direct tax in Community law", *EC Tax Review* 2003, 74: *"rule of reason justifications […] amount in practice to grounds for the conclusion that there is an objective, relevant difference between the domestic and the trans-frontier situation"*.

[2039] E.g. C-418/07, *Papillon*, § 27; C-337/08, *X Holding*, § 22.

[2040] E.g. C-446/03, *Marks & Spencer*, § 49-50; C-196/04, *Cadbury Schweppes*, § 51 *et seq.*; C-231/05, *Oy AA*, § 58-59.

[2041] E.g. C-446/03, *Marks & Spencer*, § 47-48; C-414/06, *Lidl Belgium*, § 35-36.

[2042] E.g. C-204/90, *Bachmann*, § 21-28; C-300/90, *Commission v Belgium*, § 14-21.

[2043] C-250/95, *Futura*, § 20-22.

[2044] E.g. C-446/03, *Marks & Spencer*, § 45-46; C-231/05, *Oy AA*, § 48-56; C-414/06, *Lidl Belgium*, § 31-34.

[2045] E.g. C-101/05, *A*, § 54 *et seq.*; C-318/07, *Persche*, § 70.

[2046] E.g. C-264/96, *ICI*, § 28; C-35/98, *Verkooijen*, § 59; C-136/00, *Danner*, § 56.

[2047] E.g. C-279/93, *Schumacker*, § 43-45; C-55/98, *Vestergaard*, § 25-26; C-520/04, *Turpeinen*, § 35-37.

perspective of the measure at issue, namely the risk of tax avoidance which is greater in the former type of situations. So this argument could also be seen as an element of the comparability-analysis. Similarly, the prevention that losses are deducted twice could be restated as a comparability-issue, in that situations covered by the domestic rule are more likely to give rise to double loss deduction than situations not covered by that rule. Since there is a relevant characteristic that differs between the situations, it could be said that there is incomparability. The same is true as regards the effectiveness of fiscal supervision. Assume, for instance, that a domestic measure imposes different accounting obligations on residents and on non-residents. Arguing that that distinction is justified on the basis of the need to ensure the effectiveness of fiscal supervision is actually the same as arguing that the situations are incomparable because it is more difficult for the tax authorities to exercise their supervision with respect to non-residents, which means that non-residents are incomparable to residents in the context of the domestic measure at issue[2048]. As noted in 2.E.I.A.a.1, the justification ground based on the principle of territoriality could also be seen as relating to the comparability of the situations, in that residents and non-residents are incomparable because of their different scope of tax liability. Finally, the need to ensure a balanced allocation of taxing powers can also be translated into a matter of comparability. For instance, a domestic measure restricting group relief for losses to groups with domestic subsidiaries could be justified on that basis, but it could also be said that a parent company with a non-resident subsidiary is incomparable to a parent company with a resident subsidiary since the risk that the balanced allocation of taxing powers is upset is greater in the first case[2049].

What all these arguments have in common is that they are inherent in the comparative attribute. Clearly, the additional administrative difficulties faced by tax authorities when exercising their jurisdiction with respect to non-residents are precisely due to those taxpayer’s non-residence. Administrative difficulties of that kind only arise where non-residents are concerned and never where residents are concerned. Consequently, that characteristic is inextricably linked with the comparative attribute and should be disregarded for the purposes of the comparability test. The same is obviously true for territoriality (see 2.E.I.A.a.1), the risk that losses are deducted twice (since that risk is caused by the involvement of another Member State), the risk of tax avoidance (idem) and the balanced allocation of taxing powers (since that is only possible where two Member States are involved).

For that reason, it cannot be accepted that these arguments give rise to incomparability. Otherwise, the situations would be incomparable by definition. But it is possible that the Court considers these arguments to be public policy objectives that must be attained in the general interest. For instance, while it is true that greater administrative difficulties are inherently linked with the taxpayer’s residence, it is nevertheless possible that a domestic measure is justified on that basis (provided that it is suitable and proportionate). Similarly, it is true that concerns relating to the balanced allocation of taxing powers are inherently caused by the fact that non-residents are involved, but that does not mean that the objective of protecting that balanced allocation is not a public policy objective in the general interest. Consequently, a measure that is suitable to safeguard the balanced allocation and is proportionate to that aim may be justified.

To conclude, all characteristics that are relevant from the perspective of the domestic measure at issue should be considered in the comparability-test. But when those characteristics are inherent in the comparative attribute, they must be disregarded. Nevertheless, it is possible

[2048] See also 2.E.I.A.b.8.
[2049] On the question whether fiscal cohesion is a matter of comparability, see hereafter.

that certain characteristics that are inherent in the comparative attribute relate to public policy objectives which may justify discrimination. For that reason, it is possible that arguments that were discarded from the comparability-analysis on the basis that they are inherent in the comparative attribute, reappear in the justification-analysis.

This line of reasoning has important repercussions for the Court's case law concerning the influence of tax treaties on the comparability-test. As discussed in 2.E.I.A.b.9, the Court has held that benefits provided for in a tax treaty concluded by a Member State cannot be extended to residents of a Member State not party to that treaty if those benefits contribute to the overall balance of the treaty. The reason for this conclusion is that the Court considers that the applicability of the tax treaty renders the situations incomparable because the scope of application of a tax treaty is inherently subject to the principle of reciprocity. But it is clear that the applicability of the tax treaty is generally inherent in the taxpayer's residence in a contracting State. That is to say, most tax treaties are only applicable to residents of the contracting State. And since characteristics that are inherent in the comparative attribute should be disregarded when making the comparison, it cannot be said that the applicability of the tax treaty renders a resident of a non-contracting State incomparable to a resident of a contracting State. Instead, the reasons underlying the Court's conclusion, namely the balance and reciprocity of a tax treaty, should only be taken into account in the justification-test.

III.B. Fiscal cohesion

Fiscal cohesion is something of a mysterious concept that is invoked very often by Member States to defend their tax systems, but has only rarely been accepted by the Court. For that reason, there have been serious doubts whether this concept has any added value for the Court's case law[2050]. In fact, it has been suggested that fiscal cohesion is in reality a way of saying that the situations are incomparable[2051] and that cohesion should therefore be incorporated in the comparability-test, rather than function as a separate justification ground. In order to appreciate the extent of this argument, it is necessary to trace back the roots of the fiscal cohesion-reasoning.

a. Back to Bachmann

The Court's position

The concept of fiscal cohesion was introduced in the ECJ's 1992 judgment in *Bachmann*[2052], which has has provoked severe criticism for this very reason[2053]. At issue was the Belgian tax regime on pensions and life insurance contracts. Belgian legislation provided that pension and life insurance contributions could only be deducted from occupational income if they were paid in Belgium, either to a Belgian undertaking or to the Belgian establishment of a foreign

[2050] Fiscal cohesion is such an enormous topic that an exhaustive overview of the Court's case law in this field goes beyond the scope of this study. Therefore, I will not go into the specifics of the concept's meaning as a justification ground, nor will I discuss its merits in this context. Instead, I will only discuss the question whether cohesion should function as an aspect of comparability. For this purpose, it is necessary to give a brief overview of the evolution of the concept.
[2051] R. LYAL, "Non-discrimination and direct tax in Community law", *EC Tax Review* 2003, 73.
[2052] ECJ 28 January 1992, C-204/90.
[2053] E.g. P. WATTEL, "Red herrings in direct tax cases before the ECJ", *LIEI* 2004, 92-93; B. KNOBBE-KEUK, "Restrictions on the fundamental freedoms enshrined in the EC Treaty by discriminatory tax provisions - ban and justification", *EC Tax Review* 1994, 74-85; L. HINNEKENS and D. SCHELPE, "Case law of the ECJ. Bachmann and Commission v Belgium", *EC Tax Review* 1992, 58-62.

undertaking. The Belgian system was a classical 'EET-system': contributions were exempt (i.e. deductible), the capital build-up was exempt and the eventual disbursement was taxed. On the other hand, if the contributions were not deducted, the later benefits were exempt (i.e. a 'TEE-system')[2054].

Mr Bachmann, a German national employed in Belgium, wanted to deduct contributions paid in Germany pursuant to sickness and invalidity insurance contracts and a life assurance contract concluded prior to his arrival in Belgium from his total occupational income. The Belgian tax administration refused the deduction. Eventually the ECJ was asked whether the Belgian regime infringed the free movement provisions by restricting the deductibility to contributions paid in Belgium[2055].

The Belgian government argued that the non-deductibility in Belgium did not cause a disadvantage for nationals of other Member States because the payments they eventually received under the contract were exempt in Belgium (TEE; cf. supra). Thus, even though nationals of other Member States who were employed in Belgium and who were beneficiaries of such contracts previously concluded in another Member State were unable to deduct the contributions from their total taxable income in Belgium, the pensions, annuities, capital sums or surrender values paid to them by the insurers under those contracts did not constitute taxable income in Belgium. If they were obliged, on returning to their country of origin, to pay tax on such sums, that obligation did not arise by reason of any restriction on the freedom of movement for workers imposed by Belgian law but from the absence of harmonization of the fiscal laws of the Member States.

The Court disagreed, noting that the Belgian measure did cause a disadvantage for nationals of other Member States. Particularly nationals of other Member States would be prevented from deducting their contributions without receiving the corresponding benefit of exemption from tax on the sums payable by the insurers, as they were more likely to return to their State of origin after working in Belgium where those sums were liable to tax. Even though this disadvantage resulted from the absence of harmonization of the fiscal laws of the Member States, *"such harmonization cannot constitute a condition precedent to the application of Article 48 of the Treaty"*[2056].

[2054] For a detailed analysis of these systems, see D. WILLIAMS, "The taxation of cross-border pension provision", *European Taxation* 2001, supplement No. 1, 2-8.

[2055] The Court made the bulk of its analysis from the perspective of the free movement of workers. The issues concerning the freedom to provide services and the free movement of capital are not dealt with here, as they are irrelevant to the present discussion.

[2056] C-204/90, *Bachmann*, § 10-11. It might seem difficult to reconcile this broad statement with subsequent judgments such as *Gilly*, where the Court held that disadvantages due to disparities fall outside the scope of the Treaty freedoms (see supra). However, it should be stressed that the disadvantage at issue in *Bachmann* was the non-deductibility of contributions paid to non-qualifying entities. That disadvantage was clearly due to the Belgian legislation. The Belgian government, however, argued that the actual disadvantage was the possibility that a taxpayer would be unable to deduct the contributions in Belgium, but would nevertheless be taxed after returning to his State of origin. The Court disagreed. The mere non-deductibility was sufficient to constitute a disadvantage, as this worked mainly to the detriment of nationals of other Member States. This disadvantage would indeed be removed if all tax systems were harmonized (for instance, if all Member States applied a TEE-system), which could ensure that the non-deductibility in Belgium would be counterbalanced by an exemption of the payment in the other Member State, but that was not the point. The issue in *Bachmann* was that the Belgian measure treated nationals of other Member States less favourably because they were (generally) unable to deduct their contributions. However, as will become apparent below, the connection between the deductibility of the contributions and the taxability of the payments would be decisive in the justification-analysis.

In order to justify the measure, the Belgian government relied on the need to maintain the cohesion of the national tax system. In this respect, the ECJ held that, under the Belgian rules, there was *"a connection between the deductibility of contributions and the liability to tax of sums payable by the insurers under pension and life assurance contracts"* because those sums were exempt from tax where there had been no deduction of contributions (TEE)[2057]. According to the Court, it followed that in such a tax system the loss of revenue resulting from the deduction of the contributions was offset by the taxation of pensions, annuities or capital sums payable by the insurers (EET). Where such contributions had not been deducted, those sums were exempt from tax (TEE).

Therefore, *"the cohesion of such a tax system, the formulation of which is a matter for each Member State, […] presupposes that, in the event of a State being obliged to allow the deduction of life assurance contributions paid in another Member State, it should be able to tax sums payable by insurers"*[2058]. In other words, the connection between the deductibility of the contributions and the taxability of the benefits paid explains why Belgium can refuse the deductibility for contributions in respect of policies with foreign insurers: if Belgium were to allow such deductibility, the cohesion would be disrupted, as Belgium is unable to subject those foreign insurers on the benefits paid, nor is it able to tax such benefits paid to persons who do not live in Belgium anymore when the payment is made[2059]. And since there were no less burdensome measures available to ensure the cohesion, the measure was justified[2060].

<u>The Advocate General's position</u>

The fiscal cohesion-argument in the Court's reasoning was inspired by an argument addressed by Advocate-General Mischo in his opinion in the *Bachmann*-case[2061]. In the context of the justification-analysis, the Belgian government referred to an earlier insurance-case in which the ECJ had acknowledged that the freedom to provide services may be restricted by professional rules governing the exercise of the insurance activities in order to protect policy-holders and insured persons[2062]. Referring to this argument, the Belgian government contended that the need for effective fiscal supervision required foreign insurance companies and pension funds to have an establishment in Belgium.

The Advocate-General examined this argument extensively[2063]. He first observed that the insurance-case referred to by the Belgian government suggested that the requirement of a PE in the State where the service is provided could possibly be justified. However, he

[2057] C-204/90, *Bachmann*, § 21, referring to C-300/90 *Commission v Belgium*, which was decided on the same day as *Bachmann* and dealt with the same issues.
[2058] C-204/90, *Bachmann*, § 21-23.
[2059] The logical relationship between the deductibility of the contributions and the later taxation of the benefits is illustrated by the later *Danner*-case (C-136/00, *Rolf Dieter Danner*, 3 October 2002). Under the Finnish tax system at issue in *Danner*, pensions payable by foreign institutions to Finnish residents were taxed, irrespective of whether the insurance contributions paid to build up such pensions were or were not deducted from the taxable income of their recipients. Consequently, the denial of the deduction was not justified, because the national measure at issue lacked coherence: the denial of deduction was not connected to a later exemption of the benefits. Put briefly, the Finnish system was incoherent: no deduction *and* no exemption (cf. C-136/00, *Danner*, § 35-38).
[2060] C-204/90, *Bachmann*, § 24-28.
[2061] Joined Opinions of Advocate-General Misscho in C-204/90, *Bachmann* and C-300/90, *Commission v Belgium*, 17 September 1991. Unlike the Court, the Advocate-General discussed both cases in a single opinion.
[2062] C-205/84, *Commission v Germany*, 4 December 1986, § 27.
[2063] Joined Opinions of Advocate-General Misscho in C-204/90, *Bachmann* and C-300/90, *Commission v Belgium*, § 19 *et seq*.

immediately added that that did not mean that an insurance company must necessarily have a PE in the State where it provides its services in order for effective fiscal supervision to be possible. Instead, the Advocate-General offered a middle ground-position, referring to a provision of a proposed Directive on the harmonization of income tax provisions with respect to freedom of workers. Under that provision, tax advantages granted in relation to payments made to residents could not be denied for the sole reason that the recipient was a resident of another Member State. However, it was not prohibited to require the non-resident recipient to be subject to similar tax obligations to those which would be required of a resident recipient[2064]. According to the Advocate-General, it was in accordance with the spirit of that provision for Belgium, first, to make deductibility of the premiums conditional on the insurance company being granted approval for providing its services within Belgium and, secondly, to oblige the company periodically to send a statement of the contributions paid by Belgian residents.

The Advocate-General then addressed the feature of the Belgian tax system that would inspire the fiscal cohesion-argument: *"an additional argument in favour of a subtle approach to the issue emerges from the fact that there exists, in the case of life assurance contracts […], a* ***correlation*** *between the non-deduction of premiums and the non-taxability of the capital built up by means of those premiums"*[2065]. Since Belgium accepted the deduction of the premiums only on the condition that it was able to subsequently tax the capital realized, it had to be in a position to ensure that the capital was taxed if the premiums had been deducted. If the capital was paid out abroad, which would be the case if the worker left Belgium to return to the country in which he concluded his insurance contract, it would be highly doubtful that Belgium would be unable to tax him and *"thus be able to ensure that the deduction of the premiums is '****compensated****' by the taxing of the capital fund. Where, on the other hand, an insurance company established in Belgium is involved, it will always be open to the Belgian State to ensure directly, by applying to that company, that the capital is taxed, in particular by means of the retention at source of the tax due"*[2066].

Even though the Advocate-General's opinion does not use the word 'cohesion', it is clear that the ECJ has based its fiscal cohesion-reasoning on the arguments set out in the opinion, particularly the reference to the correlation between the non-deduction of premiums and the non-taxability of the capital built up by means of those premiums, and the fact that the

[2064] Article 9(2) of the proposal of the Directive submitted by the Commission to the Council on 21 December 1979 concerning the harmonization of income tax provisions with respect to freedom of workers within the Community, *O.J.* 1980 C 21, 6.
[2065] Joined Opinions of Advocate-General Misscho in C-204/90, *Bachmann* and C-300/90, *Commission v Belgium*, § 24 (emphasis added).
[2066] *Id.* (emphasis added). However, the measure was not proportionate since the same objective could be attained by less burdensome measures. For instance, in Denmark and the Netherlands, the tax exemption of insurance contributions was inextricably linked to the taxation of the capital at the time when it was paid out. The insurance companies were obliged to retain the tax at source and to pay it over to the State, to which they were liable to make such payment. For that reason, legislation had been introduced requiring such tax to be paid even where the policy-holder no longer resided in the country at the time when the capital was paid out. Therefore, the legislation in those countries ensured that a person finding himself in Mr Bachmann's situation would be able to deduct the insurance contributions from his income tax (*Id.*, § 26). Additionally, Belgium had less burdensome arrangements with France, Luxembourg and the Netherlands: contributions could be deducted in respect of group insurance taken out with an undertaking established in one of those countries, and those undertakings had pledged to inform the Belgian tax authorities of the capital paid out to the persons in question. Accordingly, it was possible to devise administrative machinery which was able to prevent the risk of tax evasion. Since the Belgian measure made it completely impossible to deduct contributions paid to insurance companies having no establishment in Belgium, it went beyond what was necessary to achieve its intended aim. As a result, it was incompatible with the freedom to provide services.

deduction of the premiums is 'compensated for' by the taxing of the capital. It is remarkable that these arguments appear as aspects of the Advocate-General's examination of the related justification grounds of effective fiscal supervision and the risk of tax evasion. More specifically, the correlation seems to be an additional argument in favour of 'a subtle approach', i.e. 'the middle course' between two solutions which represent extremes of the spectrum: on the one hand the idea that the need for effective fiscal supervision can never justify the requirement for insurers to maintain a PE in the State where the services are provided, on the other hand the idea that that the need for effective fiscal supervision necessarily requires such an establishment[2067]. Neither idea is correct in the Advocate-General's 'subtle approach'. Instead, the requirement of a PE may be justified by the need for effective fiscal supervision, on the condition that the proportionality-test has been met[2068]. Given the feasibility of alternative (less burdensome) solutions, the Advocate-General concludes that the Belgian measure went beyond what was necessary to reach its objective. Since this idea of correlation played a relatively minor role in the Advocate-General's reasoning, it is remarkable that the Court subsequently accepted this correlation (under the guise of 'fiscal cohesion') as a sufficient stand-alone justification.

Several commentators have criticised the *Bachmann*-judgment because of the Court's finding that the cohesion of the national tax system (i.e. the connection between deduction and later taxation) could not be ensured through less restrictive measures than the refusal of deduction[2069]. For instance, Belgium could have granted Mr Bachmann the deduction as long as he resided in Belgium. If necessary, it could have recaptured the deduction upon later loss of tax jurisdiction (i.e. upon emigration of Mr Bachmann). As long as there remained a connecting factor with the jurisdiction which could ensure the later taxation (the insurer, the client or the insured capital), there was no risk of a tax coherence breach. Accordingly, an exit tax would be a less restrictive measure to attain the same objective[2070].

Moreover, it may be argued that the Court failed to take account of the possible consequences of tax treaties in *Bachmann*-type situations. The effect of such treaties might be that, even though the contributions were made to a Belgian insurance company, the eventual benefits cannot be taxed in Belgium due to tax treaty provisions corresponding to Article 18 or 21 OECD MC[2071]. Those provisions attribute the exclusive taxing rights in respect of such benefits to the recipient's State of residence. Therefore, if the taxpayer moves his residence before the contract expires, the sum paid out will not be taxable in Belgium even if the premiums were paid to a Belgian insurance company. In such a case, the connection between deductibility and future taxation is lost, which means that the fiscal cohesion-argument can no longer be upheld (see also infra, on *Wielockx*). In other words, Belgium itself sets aside the alleged coherence of its tax system by waiving the right to tax the capital payments in the tax treaty. This observation makes it hard to maintain that the perceived cohesion can justify an infringement on the free movement provisions.

[2067] *Id.*, § 21-24.
[2068] *Id.*, § 25-28.
[2069] E.g. L. HINNEKENS and D. SCHELPE, "Case law of the ECJ. Bachmann and Commission v Belgium", *EC Tax Review* 1992, 61; P. WATTEL, "Red herrings in direct tax cases before the ECJ", *LIEI* 2004, 93.
[2070] B. TERRA and P. WATTEL, *European tax law*, Deventer, Kluwer, 2005, 109. Interestingly, the same was true for the subsequent *Wielockx*-judgment (see infra): the measure was disproportionate because its objective could be attained with less restrictive measures.
[2071] L. HINNEKENS and D. SCHELPE, "Case law of the ECJ. Bachmann and Commission v Belgium", *EC Tax Review* 1992, 61.

b. Later evolution: the requirement of a direct link

In subsequent judgments, the ECJ has refined (and perhaps even scaled back) the concept of fiscal cohesion by consistently holding that cohesion requires a direct link between the tax benefit and the subsequent taxation[2072]. In other words, there must be a correlation between the tax deduction or benefit and the taxation with respect to the same taxpayer and the same tax, within the same Member State and under one and the same single tax rule[2073].

The facts of *Wielockx* (which were described in 2.E.I.A.b.1.a.2) were quite similar to those of *Bachmann*, so it was not surprising that the Dutch government relied on fiscal cohesion to justify the measure at issue. That principle would be endangered if a non-resident could set up a pension reserve in the Netherlands and thereby secure a right to a pension: the pension would not be taxed in the Netherlands because the tax treaty between Belgium and the Netherlands allocated the exclusive taxing power to the State of residence.

The ECJ points out that the effect of tax treaties following the OECD Model is that the State in question taxes all pensions received by its residents, whatever the State in which the contributions were paid, but, conversely, waives the right to tax pensions received by non-residents even if they derive from contributions paid in its territory which it treated as deductible. The Court concludes therefore that fiscal cohesion has "*not […] been established in relation to one and the same person by a strict correlation between the deductibility of contributions and the taxation of pensions but is shifted to another level, that of the reciprocity of the rules applicable in the Contracting States. Since fiscal cohesion is secured by a bilateral convention concluded with another Member State, that principle may not be invoked to justify the refusal of a deduction such as that in issue*"[2074]. In other words, by waiving its taxing rights in respect of the pension payments under a tax treaty, the Netherlands gave up the cohesion of its system as regards the correlation between deductibility of the contributions and the taxation of the pension payments[2075].

> There is an additional point to be addressed, which explains why fiscal cohesion would fail in *Wielockx* even if the tax treaty had been disregarded. In *Bachmann*, the pension payments were made by a non-resident entity in respect of which the Belgian tax administration had no jurisdiction. In contrast, the contributions in *Wielockx*

[2072] E.g. in the case of pensions: between the deductibility of the contributions and the possibility to tax the sums payable by the pension fund or insurer.

[2073] E.g. C-80/94, *Wielockx*, 11 August 1995, § 23-25; C-484/93, *Svensson and Gustavsson*, 14 November 1995, § 18; C-107/94, *Asscher*, 27 June 1996, § 55-60; C-35/98, *Verkooijen*, § 57-58; C-136/00, *Danner*, 3 October 2002, § 36-41; C-168/01, *Bosal*, 18 September 2003, § 29-36. For an overview, see F. VANISTENDAEL, "Cohesion: the phoenix rises from his ashes", *EC Tax Review* 2005, 211-217.

[2074] C-80/94, *Wielockx*, § 24-25.

[2075] See also the Opinion of Advocate-General Léger in C-80/94, *Wielockx*, § 54-55: *"The effect of the [tax treaty] is that the cohesion applies* ***at another level****: the State taxes all pensions received by residents in its territory, whatever the State in which the contributions were paid. Conversely, it waives the right to tax pensions received abroad even if they derive from and are made in consideration of contributions paid in its territory which it treated as deductible. […] The result is a pension system set up for self-employed persons which does not require a rigorous correlation between deductibility of contributions and taxation of pensions in order to secure its cohesion"* (emphasis added). It has been argued that Article 18 of the tax treaty could not be applied to the facts of *Wielockx*, and that, instead, the 'other income' Article had to be applied with the result that the Netherlands had not waived its taxing rights in respect of the pension payment (e.g. W. VERMEEND, "The Court of Justice of the European Communities and direct taxes: Est-ce que la justice est de ce monde?", *EC Tax Review* 1996, 54). Even if this were so on the facts of *Wielockx*, the general conclusion to be drawn from the Court's reasoning remains the same: where a Member State has waived its taxing right in respect of the relevant payment under a tax treaty, it is possible that cohesion has been shifted to the level of the tax treaty.

consisted of profits that were set aside annually in Mr Wielockx' business. Accordingly, the pension reserve from which the payments were to be made was still available in the undertaking established in the Netherlands, even when the beneficiary of the payments was a non-resident. Consequently, the Dutch government could have levied a withholding tax on the pension payment. By ensuring taxation of the pension payment, the Netherlands could thus safeguard the correlation between deductbility of the contributions and subsequent taxation of the payments. As a result, there was a less restrictive measure available to ensure fiscal cohesion, meaning that the Dutch measure was not proportionate[2076].

A similar approach with respect to fiscal cohesion and tax treaties was taken in subsequent judgments, for instance in *Weidert*[2077]. The Luxembourg legislation at issue in that case granted income tax relief to resident individuals for the acquisition of shares in companies established in Luxembourg. No such relief was available in respect of the acquisition of shares in companies established in other Member States. The Luxembourg government argued that the restriction to shares in Luxembourg companies was intended to ensure the cohesion of the tax system: the tax advantage, i.e. the tax relief for the acquisition of shares in Luxembourg companies, was offset by the taxation of dividends subsequently paid by those companies. In contrast, where an investment was made in a Belgian company, as in the case at hand, tax on dividends would be reduced because Luxembourg would have to grant relief for the 15% withholding tax imposed by Belgium under the Belgian/Luxembourg tax treaty. In such a case, Luxembourg would thus forgo the right to part of the tax. According to the Luxembourg government, there was thus a direct connection, involving one and the same taxpayer, between the grant of the tax advantage and the offsetting of that advantage by a subsequent fiscal levy, both of which relate to the same tax.

The ECJ dismissed the cohesion argument because there was no direct link between the tax advantage in question and an offsetting fiscal levy. First, there was no guarantee that the companies concerned would pay dividends, the taxation of which could offset the tax benefit granted. Secondly, even if dividends were paid to the recipients of the tax advantage, the amount of that advantage would significantly exceed any benefit which could result from any subsequent taxation of the dividends. The Court continues: *"In any event, even if a link were to exist under Luxembourg law between the tax advantage and the taxation of dividends, it must be held that the effect of the [Belgian/Luxembourg tax treaty] is to shift fiscal cohesion to the level of the reciprocity of the rules applicable in the Contracting States […]. The [tax treaty] creates a fiscal reciprocity, insasmuch as in forgoing 15% of the net amount of dividends paid by companies established in Belgium to individuals subject to Luxembourg income tax, Luxembourg may in return receive 15% of the dividends paid by companies having their seat in that Member State to individuals subject to income tax in Belgium. As the specific aim of the [tax treaty] is to secure fiscal cohesion, that [treaty] may not be invoked to*

[2076] See also the Opinion of Advocate-General Léger in C-80/94, *Wielockx*, § 59-68: *"The situation before the Court may be distinguished on a key point from that in Bachmann: […] in the latter case the Belgian State could not tax the annuities or benefits paid either at source or in the hands of the recipient. Here the situation is entirely different: until liquidated, the pension reserve never leaves the assets of the undertaking and is subsequently liquidated* ***by the undertaking*** *either as capital or as periodic payments in respect of which the debtor is the undertaking itself and the creditor is the beneficiary of the pension reserve. Clearly tax cannot be levied on the latter: he is non-resident. It may however be levied at source on the undertaking which is – by definition – established in the Netherlands. In Bachmann, the Court ruled that an undertaking by an insurer* ***established in another Member State*** *to pay such tax could not constitute an adequate safeguard. Here the debtor in relation to the pensions – the undertaking – remains* ***established in the Netherlands****: an undertaking by it to pay the tax on the pensions would constitute an adequete safeguard"* (emphasis added).
[2077] C-242/03, *Weidert*, 15 July 2004.

justify an inconsistency as regards the taxpayer […]"[2078]. So once again, fiscal cohesion failed because Luxembourg had waived the right to tax the dividend distribution.

What is remarkable in both cases, in *Wielockx* as well as *Weidert*, is that the Court notes that the effect of the tax treaty was *"to shift fiscal cohesion to the level of the reciprocity of the rules applicable in the Contracting States."* This might seem strange, as the reason why the Court involved the tax treaty in its reasoning was to demonstrate that the Member State in question had broken the relevant direct link by concluding a tax treaty and waiving its taxing right in respect of the subsequent pension or dividend payment. Accordingly, it would seem that cohesion was off the table at that point. However, the Court seems to imply that there is still cohesion, albeit not at a purely domestic level but at the bilateral (tax treaty) level.

This is in line with the general tendency in the Court's approach towards cohesion-cases to refuse arguments when they are based on cohesion between a tax benefit and subsequent taxation within one and the same tax jurisdiction. In most of these cases, the Member State whose tax system was under scrutiny only granted the tax benefit in question on the condition that the subsequent payment in respect of which the benefit was granted could be taxed in the same Member State. From a purely domestic perspective, it is coherent to do so: in order to maintain the national balance in revenue, the income should be subject to tax in the same jurisdiction which granted the tax benefit. However, such a position is clearly incompatible with the idea of an internal market, because it makes abstraction of the possible taxation of those payments in another Member State and thus make cross-border activities less attractive[2079]. By concluding a tax treaty, the Member State in question has waived its taxing rights in respect of the relevant payments, which means that the domestic direct link is broken, and that cohesion at the domestic level is off the table[2080]. However, the tax treaty also implies that the other contracting State may tax the income, which means there is still a direct link between the tax benefit and the subsequent taxation (and, hence, cohesion), but now both events take place in different Member States. As a result, fiscal cohesion dictates that the Member State in question also grants the tax benefit where the subsequent taxation takes place in the other contracting State.

Put briefly, if there is no direct link between tax benefit and subsequent taxation, fiscal cohesion will be dismissed out of hand. If there is a direct link, it is still possible that the cohesion-argument will fail, particularly when it is based on cohesion within one and the same tax jurisdiction. In such cases, where the Member State in question has waived its taxing rights in respect of the relevant payments under a tax treaty, the direct link is shifted to the level of bilateral, reciprocal obligations between the contracting States. As a result, the Member State in question is required to grant the tax benefit in situations where the relevant payment is taxable in the other contracting State.

[2078] C-242/03, *Weidert*, § 25.

[2079] See also F. VANISTENDAEL, "Cohesion: the phoenix rises from his ashes", *EC Tax Review* 2005, 216.

[2080] See also A. CORDEWENER, M. DAHLBERG, P. PISTONE, E. REIMER and C. ROMANO, "The tax treatment of foreign losses: Ritter, M & S and the way ahead", *European Taxation* 2004, 221, who consider the explanation that cohesion has *"shifted to the level of the tax treaty"* to be "almost metaphysical". They argue that the coherence at the domestic level has not simply been replaced by another coherence at the tax treaty level. Rather, the ECJ has limited the scope of the concept of cohesion, by requiring a Member State's tax system to be coherent both internally and externally, in the sense that a systematic coherence of different tax rules at the level of domestic law must not be torn apart by contradictory rules at the tax treaty level.

c. Manninen: relaxing the direct link-requirement

The Court's reasoning with respect to cohesion in *Manninen* has been referred to earlier (see 2.E.I.A.b.6.b.3). In the evolution of the cohesion-concept, *Manninen* signified an important step because it brought about a reformulation of this concept. This shift in the Court's understanding of cohesion was inspired by Advocate-General Kokott's Opinion in *Manninen*, who first noted that the ECJ has consistently required there to be a direct link between the grant of a tax advantage and the offsetting of that advantage by a fiscal levy, i.e. that both relate to the same tax and the same taxpayer. She continues: "*It is unclear whether the criteria 'one and the same taxpayer' and 'the same tax' are binding and must both be met, or whether they are only indicators - albeit strong ones - of the existence of a direct link between a tax advantage and disadvantage.*" If the former interpretation were correct, Finland could impossibly rely on fiscal cohesion, as it concerned two different taxpayers.

However, such a narrow approach is not advisable according to the Advocate-General: "*exceptionally, a link justifying the tax cohesion argument may exist if a charge on one taxpayer is offset by a relief for another. The preconditions for this are that: the tax is levied, if not on the same taxpayer then at least on the same income or the same economic process, and the legal configuration of the system ensures that the advantage accrues to the one taxpayer only if the disadvantage to the other is real and in the same amount. […] The application of these criteria is just as effective as the criterion of the same taxpayer in ensuring that justification on the grounds of cohesion of the tax system does not run out of control*"[2081].

As mentioned earlier, *Manninen* should be distinguished from *Verkooijen* because in the latter case, there was no correlation between the corporate income tax at the level of the distributing company and the tax benefit. In contrast, there was such a correlation in *Manninen*. As a result, the Advocate-General accepted that there was a direct link in the Finnish system[2082]. Ultimately, however, the Advocate-General considered the measure to be disproportionate. As discussed above, the Court eventually took the same approach in *Manninen*[2083].

The *Manninen*-approach was confirmed in *Papillon*[2084], which concerned the French group consolidation regime (see 2.E.I.A.b.4.f). That regime also provided for the neutrality of intra-group transactions, such as provisions for depreciation of shares held in other companies in the group, the transfer of fixed assets within the group, etc. The regime was not applicable to indirect subsidiaries of the parent that were held through a non-resident subsidiary (i.e. if the resident sub-subsidiary was held through a non-resident subsidiary).

The ECJ accepted that there was a direct link in the French regime between the tax advantages and the neutralisation of intra-group transactions. In particular, the regime provided for the tax consolidation of companies and, to offset this, for the neutralisation of certain transactions between the group companies. The neutralisation of intra-group

[2081] Opinion of Advocate-General Kokott in C-319/02, *Manninen*, § 53-62.
[2082] Opinion of Advocate-General Kokott in C-319/02, *Manninen*, § 64. See also J. ENGLISCH, "Taxation of cross-border dividends and EC fundamental freedoms", *Intertax* 2010, 207.
[2083] In some respects, the line of reasoning followed by the Court in *Manninen* is quite similar to that of *Wielockx*. In both cases, the Court recognized the existence of a direct link (even though that link, at least at the domestic level, was broken in *Wielockx* because of the tax treaty), but because there were less restrictive measures available to attain the same objective, the measure was ultimately held to be disproportionate.
[2084] C-418/07, *Papillon*, § 41-52.

transactions group avoided, inter alia, the use of losses twice at the level of resident companies falling under the tax integration regime. In the case of losses recorded by the sub-subsidiary, the subsidiary will generally provide for the depreciation of its holding in that sub-subsidiary and the parent company will, as a result, provide for the depreciation of its holding in its subsidiary. Since it concerns one and the same loss, originating at the level of the sub-subsidiary, the neutralisation mechanism results in the provision for depreciation made by the parent company and the subsidiary being disregarded if each of the companies involved is subject to the tax integration regime.

However, if the subsidiary is a non-resident company, the losses recorded by the sub-subsidiary would be taken into account twice, first, in the form of the direct losses of that sub-subsidiary and, secondly, in the form of a provision made by the parent company for the depreciation of its holding in the non-resident subsidiary. The internal transactions would not be neutralised because the non-resident subsidiary is not subject to the tax integration regime. In such circumstances, the resident companies would enjoy the advantages of the tax integration regime (as regards the consolidation of results and the immediate taking into account of the losses of all the companies subject to that regime), without the losses of the sub-subsidiary and the provisions made by the parent company being neutralised. As a result, the direct link between the tax advantages and the neutralisation of intra-group transactions would be disrupted. The Court thus concludes that, by refusing to extend the benefit of the tax integration regime to a resident parent company with resident sub-subsidiaries which it holds through a non-resident subsidiary, the French legislation had the effect of ensuring the coherence of the consolidation regime[2085].

Finally, cohesion was accepted in *Krankenheim*, the facts of which were discussed in detail in 2.E.I.A.b.3.d. Under the German legislation at issue in that case, resident taxpayers could request that losses suffered by a foreign PE were deducted from their worldwide income, provided that certain conditions were met. If the foreign PE made a profit in one of the following tax periods, the deducted amount was taken into account again (i.e. added back) in calculating the taxpayer's income, up to the amount of the profits made by the PE. Under the applicable tax treaty, Germany did not have the power to tax the income derived by the PE in the State where it was situated.

According to the Court, the German regime was justified by the need to ensure the cohesion of the tax system. The reintegration of losses provided for by the German regime could not be dissociated from their having earlier been taken into account. That reintegration, in the case of a German resident company with a PE in another State in relation to which Germany has no power of taxation "*reflects a logical symmetry. There was thus a direct, personal and material link between the two elements of the tax mechanism at issue in the main proceedings, the said reintegration being the logical complement of the deduction previously granted*". The Court then held that the measure was appropriate to achieve its objective, in that it operated in a perfectly symmetrical manner, only deducted losses being reintegrated. Moreover, it was proportionate to the objective pursued, since the losses were reintegrated only up to the amount of the profits made[2086].

[2085] Yet, the Court ultimately considered the measure to be disproportionate because it was possible to attain the objective by less restrictive measures. Particularly, France could allow taxpayers to prove that there was no risk of losses being used twice under the tax integration regime (C-418/07, *Papillon*, § 52-62).
[2086] C-157/07, *Krankenheim*, § 42-45.

d. Conclusion

From this brief overview, it seems that the Court's understanding of cohesion can be summarized as follows. First, it should be verified whether there is a direct link between the tax benefit at issue and the taxation of the relevant item of income. Such a direct link exists where the tax advantage and the taxation both relate to the same tax and the same taxpayer, but also where the tax is levied, if not on the same taxpayer then at least on the same income or the same economic process, and the legal configuration of the system ensures that the advantage accrues to the one taxpayer only if the disadvantage to the other is real and in the same amount. If there is a direct link, the measure is suitable for ensuring the cohesion of the tax system.

However, being suitable is not sufficient to comply with the justification-test. The measure must also be proportionate. In order to verify this, particular regard must be had to the objective of the measure: it must not go beyond what is necessary to attain its objective, that is to say, there are no less restrictive measures available to reach that objective. Generally, a measure inspired by fiscal cohesion serves a higher purpose, such as the need to prevent double taxation (e.g. *Manninen*), the need to ensure that income is actually taxed (e.g. *Wielockx*, *X and Y*) or the need to prevent that losses are taken into account twice (e.g. *Papillon*, *Krankenheim*)[2087]. Fiscal cohesion is an expression of the idea that there is a close connection between a tax advantage and a subsequent tax burden. However, there is also a **reason** why both are connected, and that reason is the objective pursued by the measure. For instance, a Member State could argue that a tax benefit and a subsequent tax burden are connected because if the benefit were granted without subsequent taxation in the same State, this would entail a loss in tax revenue. Since this argument has consistently been dismissed by the Court as a justification-ground, it should not be accepted as supporting the cohesion-defense[2088]. Not only must that objective be acceptable in itself, the means used to attain that objective (i.e. limiting cohesion to the domestic level) must not go beyond what is necessary. Accordingly, where, for instance, domestic cohesion is intended to guarantee that an item of income does not remain untaxed, then an exit-tax on emigrating taxpayers might be a more proportionate measure than denying the benefit altogether as regards payments made to non-residents (see supra, *Wielockx*)[2089].

Finally, it is possible that the existence of a direct link in the domestic context is, in principle, accepted, but that the cohesion-argument nevertheless fails because of the influence of a tax treaty. In this respect as well, it is important to take account of the objective of the measure. It is possible that the fulfillment of this objective is ensured at the tax treaty level, because the Member State in question has waived its taxing rights in respect of the relevant source of income. In such a case, the direct link shifts to the bilateral, reciprocal level of the tax treaty, which means that the tax benefits should be extended to situations where the taxing power lies with the other State.

[2087] See also the Opinion of Advocate-General Kokott in C-319/02, *Manninen*, § 51.

[2088] See e.g. A. CORDEWENER, G. KOFLER and S. VAN THIEL, "The clash between European freedoms and national direct tax law: public interest defences available to the Member States", *Common Market Law Review* 2009, 1970-1971 and 1975, who note that cohesion should not have been accepted in *Bachmann*, as it was nothing more than a reformulation of the 'loss of revenue' justification.

[2089] Of course, an exit tax must also be justified (and, thus, proportionate) in order for it to be an acceptable restriction of the free movement provisions. The Court has not always been entirely clear on when exit taxes are acceptable, but there are a number of useful indications in its relevant case law. See e.g. C-9/02, *De Lasteyrie*, 11 March 2004; C-470/04, *N*, 7 September 2006; G. FÜHRICH, "Exit taxation and ECJ case law", *European Taxation* 2008, 10-19.

e. From cohesion to comparability?

It has been suggested that fiscal cohesion is actually an aspect of the comparability-test, and should therefore not be used as a separate justification ground[2090]. For instance, one could rephrase the fiscal cohesion-argument in *Bachmann* as a matter of incomparability, i.e. that a taxpayer who makes contributions to a foreign pension scheme and will not be taxed on the benefits he later receives cannot be compared to a taxpayer who contributes to a Belgian scheme and will eventually be taxed there on his pension. Similarly, in *Manninen* (leaving aside the eventual finding of disproportionality in that case), one could say that a Finnish resident taxpayer receiving dividends from a resident company, which is subject to corporation tax in Finland, is incomparable to a Finnish resident taxpayer receiving dividends from a non-resident company, which is not subject to corporation tax in Finland[2091].

However, this line of reasoning would be difficult to reconcile with the Court's express finding of comparability in *Manninen* (see supra). But more importantly, there is a fundamental difference between elements of comparability and justification grounds. Obviously, a justification ground always relates differently to the object and the subject of comparison since it serves to justify the different treatment of both groups. However, using this argument to conclude that the justification is simply a form of incomparability would be a post-hoc analysis. As noted above, the essential difference between a justification ground and an element of the comparability-analysis is that the former is inherent in the comparative attribute.

That is also the case for the fiscal cohesion argument. Clearly, the cohesion of a national tax system can only be endangered where a cross-border element is involved. For instance, in *Manninen*, it was only because the distributing company was a non-resident that it was not subject to corporation tax in Finland. Consequently, the direct link between the taxation of the company's profits and the grant of the tax credit to the shareholder would only be disrupted if the distributing company was a non-resident. In other words, that risk was inherent in the comparative attribute (i.e. the distributing company's place of residence). For that reason, it cannot be argued that the justification-argument actually renders the situations incomparable. Similarly, in *Papillon*, it was only because the subsidiary was a non-resident that the direct link between the tax benefit of consolidation and the corresponding neutralisation of intra-group transactions was disrupted. So the reason why the cohesion of the national system was endangered was inherent in the comparative attribute (i.e. the subsidiary's place of residence).

[2090] E.g. R. LYAL, "Non-discrimination and direct tax in Community law", *EC Tax Review* 2003, 73; P. FARMER, "EC law and national rules on direct taxation: a phoney war?", *EC Tax Review* 1998, 21-22; P. WATTEL, "Fiscal cohesion, fiscal territoriality and preservation of the (balanced) allocation of taxing power; what is the difference?", in D. WEBER (ed.), *The influence of European law on direct taxation. Recent and future developments*, Kluwer Law International, Alphen aan den Rijn, 2007, 143-144. See also the Opinion of Advocate-General Geelhoed in C-524/04, *Thin Cap GLO*, § 89-90: *"In my view, however, in the vast majority of cases in which the Court has rejected [cohesion], it has in reality simply been expressing the basic non-discrimination principles that I have outlined in my Opinions in the ACT case, the FII case, Kerkhaert and Morres, and Denkavit, namely: (1) if acting in home State capacity, Member States must not discriminate between foreign-source and domestic-source income insofar as they exercise tax jurisdiction over the former; and (2) if acting in source State capacity, Member States must not discriminate between non-residents' and residents' income, insofar as they exercise tax jurisdiction over the former. […] In such cases, therefore, assessment of the applicability of the fiscal cohesion defence was in fact conceptually indistinct from that of determining whether national legislation is discriminatory. In the vast majority of cases, therefore, one could indeed question whether the defence of 'fiscal cohesion' really has any useful separate function."*

[2091] Another example can be found in C-386/04, *Stauffer*. As discussed in 2.E.I.A.b.10.a, the same argument was brought forward in that case both in the comparability-test and in the justification-test.

That was also the case in *Krankenheim*, where there was a risk of double loss deduction (and, therefore, a direct link between the deduction in Germany and the subsequent add-back) if the taxpayer exercised his activity through a foreign PE. Once again, the cohesion argument is inherent in the comparative attribute (i.e. the exercise of an activity through a PE in another Member State). As a result, it would be incorrect to argue that fiscal cohesion is actually an element of incomparability and should therefore be excluded from the justification-analysis.

3. Can the ECJ's analysis be improved? Lessons from the U.S. Supreme Court

A. Introduction

I. A weakness in the ECJ's analysis

In its desire to abolish obstacles to the Internal Market, the ECJ has declared several national tax measures to be discriminatory and therefore incompatible with the idea of a common market without internal borders. As is the case with most ambitious projects, the ECJ's case law in the area of direct taxation has drawn severe criticism. According to several commentators, the Court has transgressed the limits imposed by the institutional framework of the EU by infringing upon the tax sovereignty of the Member States. The criticism most often voiced in this regard is that the ECJ, in its drive to strike down impediments to the common market, tends to find tax discimination where there is none.

In particular, the ECJ sometimes fails to distinguish between cases of discrimination and cases of disparity. Disparities in treatment, which result from the interplay between the Member States' tax systems, do not fall foul of the free movement provisions. The ECJ cannot remove disparities: harmonization is necessary in order to do so. Clearly, the distinction between disparities and discriminations is of the utmost importance for the tax sovereignty of the Member States. The free movement provisions prohibit Member States from enacting discriminatory measures, but they remain free to design their tax system as they wish, by setting the tax rates and defining the taxable base, so long as they refrain from introducing discriminatory distinctions. In some cases, however, the ECJ seems to conclude that discrimination exists in cases of disparity.

II. The case law of the U.S. Supreme Court and its relevance for the ECJ

Without aiming to offer a solution to all conceivable problems, it might be interesting to gaze across the Atlantic, and find out how issues of tax discrimination are dealt with by the U.S. Supreme Court. In its case law under the Commerce Clause, the U.S. Supreme Court does not look for a comparable internal situation when assessing whether tax discrimination exists, but rather tries to universalise the measure, and considers whether cross-border economic activity would systematically be disfavoured if the measure was applied by all fifty states. Thus, the focus is not placed on the comparison of the complaining taxpayer and his internal counterpart, but on the overall impact the measure has on cross-border trade. Given the ECJ's role as the guardian of the Internal Market, this test might offer some useful insights when trying to remedy the flaws of the method currently applied by the ECJ[2092].

It should always be borne in mind, however, that non-discrimination is by its very nature a comparative affair. A comparison is made in the U.S. Supreme Court's test as well, but it could be argued that the comparison is less likely to lead to erroneous conclusions, as the factual circumstances to be taken into account are simplified.

A study as concerned with comparability and justifications as the study of tax discrimination of course requires the comparison of two different bodies of case law to be justified. At first glance, the differences might seem vast, and comparability an illusion. Indeed, the U.S. Constitution does not contain explicit free trade provisions comparable to the EU fundamental freedoms. Furthermore, the role of both Courts and the context in which they operate are very different.

Nevertheless, a comparison is justified for several reasons. First of all, both the United States and the European Union were founded in part in order to remove existing barriers to trade and economic development[2093]. The Philadelphia Convention of 1787 was intended to address and resolve existing divides between the thirteen colonies. Among the reasons for these divides were customs barriers and other economic impediments[2094]. Similarly, the Treaty establishing the European Economic Community of 1957 was aimed at creating a common market[2095]. Some thirty years later, the Single European Act[2096] tried to remove remaining barriers and improve free trade between the Member States by creating an Internal Market, *"an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured"*.

Secondly, both the U.S. Constitution and the EU Treaty provide for a system of divided competencies in the area of direct taxation. Despite the different manner in which the taxing

[2092] It should be stressed that the purpose of this study is not to compare the ECJ's approach to direct tax cases to that of the U.S. Supreme Court. The discussion of the U.S. Supreme Court's case law is only intended to determine whether the internal consistency test as developed by that court is a suitable tool for distinguishing between cases of discrimination and disparities. For a fairly recent comparison of the ECJ's case law and the U.S. Supreme Court's approach in direct tax matters, see T. KAYE, "Tax discrimination: a comparative analysis of U.S. and EU approaches", *Florida Tax Review* 2005, 47-132. For a general comparison, see also M. POIARES MADURO, *We the Court*, Oxford, Hart Publishing, 1998, 89-98.

[2093] It should be noted from the outset that I will not discuss the merits of fiscal federalism in this study. I will not engage in a debate on the desired amount of harmonization or the pros and cons of decentralized taxation. The object of the present inquiry is not the goal pursued by the ECJ, but rather the tools employed in trying to realize this goal. Starting from the premise that the Internal Market requires the abolition of fiscal barriers, I will verify whether the standard wielded by the ECJ is suitable for that purpose.

[2094] E.g. M. FARRAND (ed.), *The records of the Federal Convention of 1787*, New Haven, Yale University Press, 1911, Vol. III, 547-548: *"The same want of a general power over Commerce led to an exercise of this power separately, by the States, wch not only proved abortive, but engendered rival, conflicting and angry regulations. Besides the vain attempts to supply their respective treasuries by imposts, which turned their commerce into the neighbouring ports, […] the States having ports for foreign commerce, taxed & irritated the adjoining States, trading thro' them, as N. Y. Pena. Virga. & S- Carolina. Some of the States, as Connecticut, taxed imports as from Massts higher than imports even from G. B. of wch Massts. complained to Virga. and doubtless to other States […]. In sundry instances […] the navigation laws treated the Citizens of other States as aliens"*.

[2095] Art. 2 EEC Treaty: *"It shall be the aim of the Community, by establishing a Common Market and progressively approximating the economic policies of Member States, to promote throughout the Community a harmonious development of economic activities, a continuous and balanced expansion, an increased stability, an accelerated raising of the standard of living and closer relations between its Member States."*

[2096] Single European Act, 28 February 1986, *O.J. L.* 169 of 29 June 1987.

powers are divided, a central aim in both legal orders is the achievement of tax harmony without, however, infringing upon the States' competencies. In both legal orders, the highest courts play an important role in finding a balance between the desire to further economic integration by abolishing tax discrimination and the need to preserve States' tax autonomy. In both legal orders, the taxing powers of States are limited by the principle of non-discrimination. The different expressions of the non-discrimination principle throughout the EU Treaty have been discussed earlier.

Despite the absence of an express prohibition of tax discrimination in the U.S. Constitution, or provisions similar to the European fundamental freedoms, the U.S. Supreme Court has developed case law dealing with tax discrimination on the basis of the Commerce Clause. The Commerce Clause was included in the Constitution to stop the economic competition among the States that characterized the era of the Articles of Confederation. The goal of the Commerce Clause was to contain the ever-growing economic strife among the States and to create an "*area of trade free from interference by the States*"[2097]. Thus, both the European and the American anti-discrimination standard are founded in a common idea: the prevention of economic inefficiencies caused by discriminatory taxes (i.e. avoiding market distortions caused by protectionist State taxes and thereby protecting free trade, preventing tax exportation[2098], etc.).

Finally, both the ECJ and the U.S. Supreme Court have been confronted with a legislative vacuum in the area of direct taxation[2099], and both courts, in their case law, have tried to fill this void. As discussed earlier, the ECJ has, since its first direct tax case in 1986, gradually picked up steam and struck down numerous national tax measures which are deemed to be incompatible with the Internal Market. Similarly, the U.S. Supreme Court has developed a vast body of case law dealing with federal constraints upon state taxation of interstate business.

A comparison of case law reveals that the perennial conflict between the States' interest in exercising their taxing powers and the nation's interest in preserving the economic unity is remarkably similar to the tension felt within the EU between the Member States' constant pressure to expand the tax revenues, thereby often enacting measures that affect cross-border business. On both sides of the Atlantic, the business community has responded to such measures by invoking provisions of the U.S. Constitution or the EU Treaty designed to preserve the economic unity. Both the U.S. Supreme Court and the ECJ have been confronted with the difficulties of reconciling this conflict. Both Courts have traveled a bumpy road and both have encountered similar obstacles, thereby sometimes erring on the side of confusion. Therefore, both Courts might benefit from taking a look at the travels of their transatlantic counterpart.

That being said, it should be stressed that the aim of the present study is not to give an exhaustive overview of the Supreme Court's case law in tax matters, nor to criticize that case law. The purpose of the comparison with the U.S. experience is merely to determine whether

---

[2097] Freeman v. Hewit, 329 U.S. 249, 252 (1946); cf. also the Federalist, No. XLII.

[2098] Tax exportation occurs when a State shifts the tax burden of financing local public services from its residents to non-residents.

[2099] In the EU, the vacuum is mainly due to the unanimity requirement for tax legislation (see supra). Under the Commerce Clause, the U.S. Congress has the power to regulate commerce among the States, which includes the power to prohibit certain State taxes. Historically, however, Congress has rarely exercised these powers; cf. W. HELLERSTEIN, "State taxation of interstate business: perspective on two centuries of constitutional adjudication", *Tax Lawyer* 1987, 37.

there are elements in the Supreme Court's analysis that may improve the standard applied by the ECJ, in particular with respect to the distinction between discrimination and disparity.

B. A Kantian concept: the Commerce Clause as the first formulation of the categorical imperative

I. Introduction

Unlike the ECJ, the Supreme Court has discretion in selecting which cases it will consider[2100]. As a result, only cases which are deemed to be sufficiently important will be reviewed by the Supreme Court. At least four of the nine Justices must vote to hear a case and the Court does not need to explain its refusal to hear a certain case. Despite being ostensibly reluctant to hear tax cases[2101], the Supreme Court has produced a steady stream of cases articulating the limitations on the States' power to tax interstate business.

Four provisions of the U.S. Constitution are of interest to a taxpayer wishing to challenge an allegedly discriminatory State tax: the Privileges and Immunities Clause (also known as the Comity Clause)[2102], the Equal Protection Clause[2103], the Due Process Clause[2104] and the Commerce Clause[2105]. As tax discriminations with respect to interstate commerce have most often been analysed under the Commerce Clause, the other three clauses will not be discussed here[2106].

[2100] Rules of the Supreme Court of the United States, Rule 10: *"Review on a writ of certiorari is not a matter of right, but of judicial discretion. A petition for a writ of certiorari will be granted only for compelling reasons."*
[2101] For instance, Justice Brennan reportedly hated tax cases. His normal reaction to a request for certiorari in a tax case was: *"This is a tax case. Deny."* B. WOODWARD and S. ARMSTRONG, *The Brethren. Inside the Supreme Court*, New York, Simon and Schuster, 1979, 362. Another important factor which influences the number of cases reaching the Supreme Court (and which might explain the different composition of the Supreme Court's body of case law as compared to that of the ECJ) is the specific interpretation given to the requirement of 'standing' (or 'locus standi'), i.e. "whether the litigant is entitled to have the court decide the merits of the dispute or of particular issues"; Warth v. Seldin, 422 U.S. 490, 498 (1975).
[2102] Art. IV (2) U.S. Constitution: *"The Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States"*.
[2103] Amendment XIV (1) U.S. Constitution: *"No State shall […] deny to any person within its jurisdiction the equal protection of the laws"*.
[2104] Amendment XIV (1) U.S. Constitution: *"No State shall […] deprive any person of life, liberty, or property, without due process of law"*.
[2105] Only two provisions of the U.S. Constitution refer directly to the scope of State tax power: the import-export clause (Art. I (10) cl. 2 U.S. Constitution) and the duty of tonnage prohibition (Art. I (10) cl. 3 U.S. Constitution). Neither has played a significant role in the Supreme Court's case law on State taxes impeding interstate commerce: W. HELLERSTEIN, "State taxation of interstate business: perspective on two Centuries of constitutional adjudication", *Tax Lawyer* 1987, 39-40 and W. HELLERSTEIN, "The U.S. Supreme Court's State tax jurisprudence: a template for comparison", in R. AVI-YONAH, J. HINES and M. LANG (eds.), *Comparative fiscal federalism. Comparing the European Court of Justice and the U.S. Supreme Court's tax jurisprudence*, Alphen aan den Rijn, Kluwer Law International, 2007, 71-73.
[2106] For an overview of the other three clauses, see W. HELLERSTEIN, "State taxation of interstate business: perspective on two Centuries of constitutional adjudication", *Tax Lawyer* 1987, 37-81.

II. The Supreme Court's interpretation of the Commerce Clause

II.A. General

The Commerce Clause[2107] states that *"The Congress shall have power […] to regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."*

At first sight, it seems that this clause merely contains a grant of power to Congress, without imposing any limitations on State measures affecting interstate commerce. However, since the early 19th Century, the Supreme Court has held that the clause implicitly places limitations on such measures[2108]. The Court refers to its analysis as involving 'dormant Commerce Clause' principles or 'negative Commerce Clause' principles, meaning that the mere grant of a commerce power to Congres, by implication, places limits upon State laws regulating commerce[2109]. Thus, the Supreme Court interprets the Congressional silence (i.e. the decision of Congress not to exercise its power to regulate interstate commerce) as imposing limitations on State measures affecting interstate commerce[2110].

Under the Supreme Court's interpretation of the Commerce Clause, the judiciary interprets the clause to invalidate State measures that discriminate against interstate commerce (in purpose or effect), but Congress has the power to approve such measures[2111]. In other words, Congress can authorize what would otherwise be a violation of the dormant Commerce Clause. Thus, if Congress has enacted no legislation on the subject, the Supreme Court interprets the Congressional silence and assumes that Congress intends a common market, with no State being able to enact laws that discriminate against commerce by reason of its interstate origin or destination. However, once Congress enacts a law, the Supreme Court's only role is to see if it regulates interstate commerce. If it does that (and it does not violate any other part of the Constitution), then the law is valid, even if it authorizes what a State law could not do[2112].

[2107] Art. I (8) U.S. Constitution.

[2108] Arguably, this intention was already present in the Framers' vision; e.g. in a letter to J.C. Cabell, James Madison wrote that the Commerce Clause *"was intended as a negative and preventive provision against injustice among the States themselves"*, M. FARRAND, *o.c.*, Vol. III, 478.

[2109] J. NOWAK and R. ROTUNDA, *Principles of Constitutional Law*, St. Paul, Thomson & West, 2007, 160.

[2110] No attempt will be made to give an exhaustive overview of the case law of the Supreme Court delineating the scope of State tax power over interstate business. Such an attempt would be futile, given the volume of case law and the diverse views expressed therein. Already in 1946, the Supreme Court itself was well aware of this, declaring in Freeman v. Hewit 329 U.S. 249, 252 (1946): *"The history of this problem is spread over hundreds of volumes of our Reports. To attempt to harmonize all that has been said in the past would neither clarify what has gone before not guide the future"*. Many excellent articles have been written about the evolution of this issue, some of which are: J. SHOLLEY, "The negative implications of the Commerce Clause", *University of Chicago Law Review* 1936, 556-596; P. TATAROWICZ and R. MIMS-VELARDE, "An Analytical Approach to State Tax Discrimination under the Commerce Clause", *Vanderbilt Law Review* 1986, Vol. 39, 879-960; H. HUNTER, "Federalism and State taxation of multistate enterprises", *Emory Law Journal* 1983, Vol. 32, 89-134; W. HELLERSTEIN, "State taxation of interstate business: perspective on two Centuries of constitutional adjudication", *Tax Lawyer* 1987, 37-81.

[2111] Obviously, this situation should distinguished from the situation where a State measure regulating commerce directly conflicts with federal law. Such a State measure is invalid under the terms of the supremacy clause of Art. VI U.S. Constitution (*"This Constitution, and the laws of the United States which shall be made in pursuance thereof, and all treaties made, or which shall be made, under the authority of the United States, shall be the supreme law of the land; and the Judges in every State, shall be bound thereby; any thing in the constitution or laws of any State to the contrary notwithstanding"*).

[2112] J. NOWAK and R. ROTUNDA, *o.c.*, 161.

As indicated earlier, one of the main reasons for revising the Articles of Confederation, and eventually drafting the U.S. Constitution, was the economic competition between the States and the trade barriers resulting from this competition. Under the Articles of Confederation, the federal government lacked the power to resolve such disputes. Therefore, it is quite surprising that the Constitution does not contain an express prohibition of such trade barriers. Given the purpose of the Constitutional Convention, however, it is clear that the drafters intended to limit such State measures and allow for the development of a common market.

II.B. Early developments

The evolution of the Supreme Court's case law on the application of the Commerce Clause to State measures affecting interstate commerce has not been entirely straightforward[2113]. From the end of the 19th Century, the clause was interpreted quite restrictively, as precluding States from imposing a tax on the privilege of doing interstate business[2114]. Under this 'privilege doctrine', States were precluded from imposing a tax on a corporation as a condition of commencing business in that State[2115], a principle which was later extended to preclude a State tax on the privilege of doing interstate business, even though the tax was not levied as a condition to commencing business[2116], or even though it was applied on a non-discriminatory basis to foreign and domestic corporations, and to interstate and intrastate business[2117].

In the 1930's, the Supreme Court's restrictive interpretation of the States' power to tax interstate commerce (and the notion that the Commerce Clause created an area of trade completely free of State taxation) was abandoned. Instead, the Court opted for an interpretation under which a State tax would only be invalidated if it subjected interstate commerce to a risk of taxation not borne by local commerce[2118]. Thus, under this 'multiple taxation' doctrine, a State tax would only be invalidated if by reason of the interstate nature of the business the same activities or the same income may be taxed in more than one State. The States could avoid this danger to interstate business through a properly apportioned tax. This means that each State obtains only a share of a full tax on an interstate business, with the result that local business and interstate business are (broadly speaking) in the same tax

[2113] See, for instance, Case of the State Freight Tax. Reading Railroad Company v. Pennsylvania, 82 U.S. 232 (1872), where it was held for the first time that the Commerce Clause by its own force limits State tax power over interstate commerce. In that case, the Commerce Clause was found to preclude States from imposing a tax upon interstate freight transport. In State Tax on Railway Gross Receipts. Reading Railroad Company v. Pennsylvania, 82 U.S. 284 (1872), however, the Supreme Court decided that a tax upon gross receipts of a transportation company, derived in part from interstate transportation, did not violate the Commerce Clause. The Court thus distinguished between a tax on the transportation of freight and a tax on receipts from such transportation, even though both taxes affect interstate commerce in substantially the same manner.

[2114] See J. HELLERSTEIN, "State franchise taxation of interstate businesses", *Tax Law Review* 1948, 99 and W. LOCKHART, "Gross receipt taxes on interstate transportation and communication", *Harvard Law Review* 1943, Vol. 57, 40. See also Crutcher v. Kentucky, 141 U.S. 47 (1891).

[2115] E.g. Leloup v. Port of Mobile, 127 U.S. 640, 645 (1888); Western Union Telegraph Co. v. State of Kansas, 216, U.S. 1, 47-48 (1910).

[2116] E.g. Cheney Bros. Co. v. Massachusetts, 246 U.S. 147, 153-154 (1918).

[2117] E.g. Alpha Portland Cement Co. v. Massachusetts, 268 U.S. 203.

[2118] E.g. Western Live Stock v. Bureau of Revenue, 303 U.S. 250, 258 (1938): *"we think the tax assailed here finds support in reason, and in the practical needs of a taxing system which, under constitutional limitations, must accommodate itself to the double demand that interstate business shall pay its way, and that at the same time it shall not be burdened with cumulative exactions which are not similarly laid on local business. […]The tax is not one which in form or substance can be repeated by other states in such manner as to lay an added burden on the interstate distribution of the magazine"*. See also Gwin, White & Prince v. Henneford, 305 U.S. 434 (1939) and McGoldrick v. Berwind-White Coal Mining Co., 309 U.S. 33 (1940).

position. If the State tax is fairly apportioned to the foreign taxpayer's activities in the taxing State, there is, in principle, no risk that the foreign taxpayer is subjected to a tax not borne by local commerce.

As a result of this doctrine, the Supreme Court's scrutiny of State taxes affecting interstate commerce became less strict and the traditional view that interstate commerce may not be taxed at all by the States was swept away. Taxes which were apportioned by methods which the Court thought were reasonably designed to measure the state's nexus with the property, receipts or income taxed were now deemed to be permissible. Proper apportionment thus became an increasingly important factor in the Court's analysis[2119].

The privilege doctrine further declined in 1959, when the Supreme Court recognized for the first time that an exclusively interstate business could be subjected to the States' taxing powers. In *Northwestern States Portland Cement Co. v. Minnesota*, the Supreme Court held that the net income from the interstate operations of a foreign corporation could be subjected to state taxation provided the levy was not discriminatory and was properly apportioned to local activities within the taxing State[2120]. Underlying the Court's conclusion was the argument that, *"while it is true that a State may not erect a wall around its borders preventing commerce an entry, it is axiomatic that the founders did not intend to immunize such commerce from carrying its fair share of the costs of the state government in return for the benefits it derives from within the State"*[2121]. In the decades to come, the Court consistently upheld this position[2122].

II.C. The four-part test of Complete Auto Transit

In the 1977 decision in *Complete Auto Transit*, the Commerce Clause case law culminated in a four-part test, that focused on the purpose and effect of the State tax affecting interstate commerce in order to determine whether it could withstand scrutiny under the Commerce Clause[2123]. The four steps of this test are:

1. The tax must be applied to an activity that has a substantial nexus with the State
2. The tax must be fairly apportioned to activities carried on by the taxpayer in the State
3. The tax must not discriminate against interstate commerce[2124]

[2119] W. HELLERSTEIN, *o.c.*, 49. However, the change in the Court's position was not absolute, as several cases would still be decided by relying on the old principles: e.g. Freeman v. Hewit 329 U.S. 249 (1946), Memphis Steam Laundry Cleaner v. Stone, 342 U.S. 389 (1952). As a result, the case law until the late 1950's was not entirely consistent.

[2120] Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 452 (1959)

[2121] Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 461-462 (1959)

[2122] It should be noted that the Supreme Court had played a very similar tune in Western Live Stock v. Bureau of Revenue, 303 U.S. 250, 254 (1938): *"It was not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing the business. Even interstate business must pay its way and the bare fact that one is carrying on interstate commerce does not relieve him from many forms of state taxation which add to the cost of his business."* The Court's commitment to this position, however, was not entirely certain in the 1940's and 1950's, see supra and W. HELLERSTEIN, *o.c.*, 54.

[2123] Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977).

[2124] The Supreme Court's understanding of the prohibition of discrimination will not be addressed here, since it does not add anything substantial to the analysis made under Art. 24 OECD MC and the fundamental freedoms. As a general remark, it could be pointed out that the Supreme Court has never offered a precise definition of this prohibition. The central idea throughout the case law seems to be that a State may not tax a transaction or

4. The tax must be fairly related to services provided by the State.

In decisions handed down after *Complete Auto Transit,* the Supreme Court has been quite consistent in applying this test[2125]. The four-part determination allowed for an analysis which was less formalistic than some of the tools employed in earlier case law and left more room for considering the practical effect of the tax. In the words of the Supreme Court, the *Complete Auto Transit*-test is a *"consistent and rational method of inquiry"* that examines *"the practical effect of a challenged tax"* on interstate commerce[2126]. As a result, the focus of the analysis was no longer merely on the formal phrasing or technical structure of the tax measure at issue, but rather on its practical impact on interstate commerce.

> The different steps of the *Complete Auto Transit* test overlap to some extent. For instance, the first (substantial nexus) and the fourth aspect (fair relation) are overlapping. Additionally, the second aspect (fair apportionment) could be seen as a sub-aspect of the third aspect (non-discrimination). When a State tax is malapportioned, two or more State may tax the same economic activity. When they do, interstate commerce will bear a greater overall tax burden than intrastate commerce. As the Supreme Court has recognized: *"A tax that unfairly apportions income from other States is a form of discrimination against interstate commerce"*[2127]. And that is the ultimate purpose of the Commerce Clause: ensuring that interstate commerce is not impeded by the States, for instance by introducing discriminatory tax measures. As indicated before, however, the purpose of this study is not to analyse the Supreme Court's case law in detail, but only to determine whether elements of its analysis may improve the test applied by the ECJ.

For the purpose of the present discussion, only the second step of this test is relevant. The requirement that the tax must be fairly apportioned to activities carried on by the taxpayer in the State is based on the idea that a state tax is permissible if it merely requires the taxpayer to pay his just share. In contrast, a state tax will be struck down if it exceeds this limit and the State tries to obtain more than its fair share of the tax burden on interstate commerce.

---

incident more heavily when it crosses State lines than when it occurs entirely within the State (Armco, Inc. v. Hardesty, 467 U.S. 638, 642 (1984)). Consequently, when a tax imposes greater burdens on foreign goods, activities or enterprises than on competing in-state goods, activities or enterprises, it will be struck down as discriminatory. Case law demonstrates that the Supreme Court applies this test quite strictly (e.g. Bacchus Imports, Ltd. v. Dias, 468 U.S. 263 (1984)). Furthermore, the Supreme Court will also invalidate taxes which seem to be neutral at first sight, but have a disproportionate impact on non-residents (e.g. West Lynn Creamery, Inc. v. Healy, 512 U.S. 186 (1994)) or impose a higher burden on multistate enterprises than on in-state enterprises (e.g. American Trucking Associations, Inc. v. Scheiner, 483 U.S. 266, 284 (1987)). With regard to the formulas used to divide a multistate enterprise's tax business among the States concerned, the Supreme Court has held that non-discrimination and fair apportionment are closely related. Indeed, if the formula leads to a fair apportionment, the risk of an interstate business being subject to a higher tax burden than an in-state business is averted (Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 170-171 (1983)). The Court has further indicated that possible discrimination resulting from the application of such formulas must be discerned from the existence of mere disparities (Moorman Manufacturing Co. v. Bair, 437 U.S. 267, 278 (1978)). Negative consequences resulting from the disparity between different States' formulas are not considered to be an issue of discrimination. As a result, it is up to the legislature to remove the diparities by adopting a uniform rule.

[2125] E.g. Department of Revenue of State of Washington v. Association of Washington Stevedoring Companies, 435 U.S. 734 (1978); Commonwealth Edison Co. v. Montana, 435 U.S. 609 (1981); American Trucking Associations, Inc. v. Scheiner, 483 U.S. 266 (1987); Trinova Corp. v. Michigan Dept. of Treasury, 498 U.S. 358 (1991); Fulton Corp. v. Faulkner, 516 U.S. 325 (1996).

[2126] Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425, 443 (1980).

[2127] Armco Inc. v. Hardesty, 467 U.S. 638, 644.

With regard to this requirement, the Supreme Court has upheld a wide variety of formulas used by States to divide a multistate enterprise's tax business among the States[2128]. The main issue with regard to such formulas is the risk for multistate enterprises to be burdened with multiple taxes as a result of their multistate activities. In *Moorman Manufacturing Co. v. Bair*[2129], for instance, the application of Iowa's apportionment formula in conjunction with the application of Illinois' formula resulted in a duplication of the tax burdens. However, the Supreme Court refused to invalidate the tax: *"The only conceivable constitutional basis for invalidating the Iowa statute would be that the Commerce Clause prohibits any overlap in the computation of taxable income by the States. If the Constitution were read to mandate such precision in interstate taxation, the consequences would extend far beyond this particular case. For some risk of duplicative taxation exists whenever the States in which a corporation does business do not follow identical rules for the division of income."* According to the Supreme Court, it was up to Congress (and not to the Court) to enact uniform rules for the division of income in order to prevent duplicative taxation[2130].

It was in the context of this fair apportionment test that the concept of internal consistency would be developed.

II.D. Internal Consistency and the Commerce Clause

a. The origin of the internal consistency test: Container Corp.

The 'internal consistency' criterion was first referred to in 1983, in *Container Corp. of America*, where the Supreme Court used the criterion to analyse the fairness of an apportionment formula which determined how much of the enterprise's income the States may tax[2131]. In that decision, the Supreme Court describes internal consistency as follows: *"The first, and […] obvious component of fairness in an apportionment formula is what might be called internal consistency - that is the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business's income being taxed"*[2132].

[2128] E.g. Pullmans Palace Car Co. v. Pennsylvania, 141 U.S. 18, 26 (1891); Ott v. Mississippi Valley Barge Line Co., 336 U.S. 169, 174 (1949); Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113, 120-121 (1920); Butler Bros v. McColgan, 315 U.S. 501, 509 (1942).
[2129] Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978).
[2130] 437 U.S. 267, 278-280. A similar decision was reached five years later, in Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983).
[2131] It should be noted that the Supreme Court has not always been consistent in applying ICT (see W. HELLERSTEIN, "Is 'internal consistency' foolish? Reflections on an emerging Commerce Clause restraint on state taxation", *Michigan Law Review* 1988, 138. Moreover, the Supreme Court generally does not apply ICT to issues of personal taxation, which are generally analysed under the Privileges and Immunities Clause.
[2132] Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 169 (1983). There is also a second component of fairness: *"The second and more difficult requirement is what might be called external consistency - the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated"*. This requirement, that the amount of income attributed to the State in question by the apportionment formula produces a reasonable result in light of the taxpayer's activities there, will not be addressed here (for a brief overview, see W. HELLERSTEIN, "The U.S. Supreme Court's State tax jurisprudence: a template for comparison", in R. AVI-YONAH, J. HINES and M. LANG (eds.), *Comparative fiscal federalism. Comparing the European Court of Justice and the U.S. Supreme Court's tax jurisprudence*, Alphen aan den Rijn, Kluwer Law International, 2007, 116-118.

The Supreme Court has been quite tolerant in assessing whether an apportionment formula is 'fair', even though the adoption of varying formulas by different States may in fact subject the interstate business to multiple taxation. As long as the formula is intrinsically fair, the Court has refused to invalidate it merely because the application by another State of a different intrinsically fair formula could create an overlap, as it is impossible for the Court to determine which formula is *"at fault in a constitutional sense"*[2133] in the absence of uniform rules of apportionment.

The Supreme Court's leniency is not absolute, however. A formula is no longer intrinsically fair when, if applied across all taxing States, it subjects a multistate enterprise to taxation of more than 100% of its tax base. The reason is obvious: the purpose of the Commerce Clause is the preservation of economic unity by removing tax measures that disadvantage interstate business *vis-à-vis* intrastate business. Intrinsic fairness of an apportionment formula thus logically requires that a taxpayer whose tax base is taxable in part by several States is not treated less favourably than a taxpayer whose entire tax base is taxable by a single State. Consequently, an apportionment formula is not intrinsically fair if generalized application leads to a taxation of more than 100% of the multistate enterprise's tax base[2134]. The internal consistency test therefore asks what would happen if all states applied the challenged rule.

b. Armco Inc.

The reference to internal consistency in *Container Corp.* was quite brief, and the manner in which the reference was worded might lead one to suspect the criterion has always been present in the fair apportionment requirement (*"The first, and […] obvious component of fairness in an apportionment formula is what might be called internal consistency"*). Shortly afterwards, however, the Supreme Court attributed significantly more weight to the criterion, and also applied it to substantive tax provisions (as opposed to the apportionment formulas discussed above).

At issue in *Armco, Inc. v. Hardesty*[2135] was a West Virginia 'business & occupation tax' (B & O tax), a tax which was levied on the privilege of engaging in most business activity in West Virginia, including manufacturing and wholesaling. In general, if a taxpayer engaged in multiple business activities, a tax was due on the privilege of engaging in each activity. However, a specific exemption relieved taxpayers engaging in manufacturing as well as wholesaling activities in West Virginia from the liability for the wholesaling tax (i.e. only the manufacturing tax was due). The rate of the manufacturing tax was higher than the rate of the wholesaling tax.

[2133] Moorman Manufacturing Co. v. Bair, 437 U.S. 267, 277 (1978).

[2134] See also Oklahoma Tax Commission v. Jefferson Lines, Inc, 514 U.S. 175, 184 (1995): *"Internal consistency is preserved when the imposition of a tax identical to the one in question by every other State would add no burden to interstate commerce that intrastate commerce would not also bear. This test asks nothing about the degree of economic reality reflected by the tax, but simply looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage as compared with commerce intrastate. A failure of internal consistency shows as a matter of law that a State is attempting to take more than its fair share of taxes from the interstate transaction, since allowing such a tax in one State would place interstate commerce at the mercy of those remaining States that might impose an identical tax."*

[2135] Armco, Inc. v. Hardesty, 467 U.S. 638 (1984).

An Ohio manufacturer engaged in wholesaling in West Virginia argued that the tax discriminated against interstate commerce because it taxed foreign manufacturers engaged in wholesaling in West Virginia, while exempting West Virginia manufacturers engaged in wholesale in that State. The Supreme Court agreed that the tax on its face discriminated against interstate commerce[2136]. The fact that West Virginia manufacturers were subject to the higher manufacturing tax did not remove the discrimination, because the manufacturing tax could not be viewed as substantially equivalent to the wholesaling tax[2137]. In this regard, West Virginia had advanced that the taxpayer was required *"to prove actual discriminatory impact on it by pointing to a State that imposes a manufacturing tax that results in a total burden higher than that imposed on Armco's competitors in West Virginia."*

The Supreme Court disagreed: *"This is not the test. In Container Corp. [...], the Court noted that a tax must have what might be called internal consistency - that is the [tax] must be such that, if applied by every jurisdiction, there would be no impermissible interference with free trade. In that case, the Court was discussing the requirement that a tax be fairly apportioned to reflect the business conducted in the State. A similar rule applies where the allegation is that a tax on its face discriminates against interstate commerce. A tax that unfairly apportions income from other States is a form of discrimination against interstate commerce. [...] Any other rule would mean that the constitutionality of West Virginia's tax laws would depend on the shifting complexities of the tax codes of 49 other States, and that the validity of the taxes imposed on each taxpayer would depend on the particular other States in which it operated"*[2138].

The West Virgina B & O tax failed this internal consistency test: if every State imposed such a tax, an enterprise engaged in manufacturing in State A and engaged in wholesaling in State B would pay a manufacturing tax in State A and a wholesaling tax in State B. Due to the exemption from wholesaling tax for enterprises engaged in both manufacturing and wholesaling, intrastate enterprises (i.e. enterprises whose manufacturing and wholesaling activities both take place in the same State) would only pay a manufacturing tax. As a result, intrastate enterprises would be given a competitive advantage over their interstate competitors, who are burdened with multiple taxes.

[2136] The Supreme Court has repeatedly identified tax measures, that discriminate "on their face". The Court has not yet given a precise definition of 'facial discrimination', but the characterization has been applied to a variety of measures which expressly differentiate on the basis of the in-state or out-of-state location of the taxed activity; e.g. New Energy Co. of Indiana v. Limbach, 486 U.S. 269, 275 (1988), Westinghouse Elec. Corp. v. Tully, 466 U.S. 388, 406-407 (1984). The general tenet in these cases seems to be that facially discriminatory provisions are *"virtually per se invalid"*; Fulton Corp. v. Faulkner, 516 U.S. 325, 331 (1996). This is not an absolute, however, as the Court has recognized that a facially discriminatory tax may still survive Commerce Clause scrutiny *"if it is a truly 'compensatory tax' designed simply to make interstate commerce bear a burden already borne by intrastate commerce."*; Associated Industries of Missouri v. Lohman, 511 U.S. 641, 647 (1994); Fulton Corp. v. Faulkner, 516 U.S. 325, 331 (1996); Oregon Waste Systems, Inc. v. Department of Environmental Quality of State of Or., 511 U.S. 93, 102-103 (1994): *"these principles have found expression in the 'compensatory' or 'complementary' tax doctrine. […] [T]he compensatory tax is […] a specific way of justifying a facially discriminatory tax as achieving a legitimate local purpose that cannot be achieved through nondiscriminatory means. […] Under that doctrine, a facially discriminatory tax that imposes on interstate commerce the rough equivalent of an identifiable and 'substantially similar' tax on intrastate commerce does not offend the negative Commerce Clause."*

[2137] Armco, Inc. v. Hardesty, 467 U.S. 638, 642-643 (1984).

[2138] Armco, Inc. v. Hardesty, 467 U.S. 638, 644-645 (1984). This is similar to the majority interpretation of Art. 24 OECD MC and the ECJ's application of the fundamental freedoms. As pointed out earlier, neither of those non-discrimination standards allows the taking into account of counterbalancing advantages that offset the disadvantage at issue.

In *Armco Inc.*, the internal consistency test was thus extended beyond the mere verifying of the intrinsic fairness of a State's apportionment formula, to cover situations *"where the allegation is that a tax on its face discriminates against interstate commerce."*

c. Tyler Pipe

In 1987, the Supreme Court was asked to decide a case similar to *Armco, Inc.* In *Tyler Pipe*[2139] Washington imposed a B & O tax on gross receipts from various business activities carried on in the State, including manufacturing and wholesaling. Like West Virginia, Washington had introduced a multiple activities exemption, assuring that enterprises engaged in both manufacturing and wholesaling in the State would pay tax on only one activity. However, instead of exempting wholly intrastate enterprises from the wholesaling tax, Washington exempted them from the manufacturing tax. Thus, Washington avoided facial discrimination against interstate enterprises that made wholesale sales in Washington but manufactured elsewhere, as these enterprises would pay the same tax on their wholesaling activities as their Washington-based intrastate competitors. Such a system obviously introduced a different form of facial discrimination, i.e. discrimination against interstate enterprises manufacturing in Washington and making wholesale sales elsewhere, as these enterprises paid the manufacturing tax while their Washington-based intrastate competiors did not[2140].

The Supreme Court concluded that Washington's B & O tax violated the Commerce Clause, since a generalized application of the tax would put interstate enterprises at a competitive disadvantage to wholly intrastate enterprises. If each State would adopt Washington's system, an interstate enterprise engaging in manufacturing in State A and engaging in wholesaling in State B, would pay a manufacturing tax to State A and a wholesaling tax to State B. By contrast, a wholly intrastate enterprise would only pay one tax, i.e. a wholesaling tax[2141].

[2139] Tyler Pipe v. Wash. Dept. of Rev., 483 U.S. 232 (1987). As discussed above, this study is not concerned with a detailed analysis of the Supreme Court's Commerce Clause case law. Instead, the purpose of this chapter is to consider one idea developed in this case law – namely the internal consistency test – and verify whether that idea can improve the non-discrimination analysis under the fundamental freedoms. The cases discussed here only serve to illustrate how ICT can be applied. Consequently, I will not discuss the evolution of internal consistency after its basic conception was formulated (i.e. after 1987). For an overview of that later evolution, see W. HELLERSTEIN, "Is internal consistency dead? Reflections on an evolving Commerce Clause restraint on State taxation", *Tax Law Review* 2007, 1-51.

[2140] The argument that the Washington manufacturing tax on local goods sold outside the State functioned as a 'compensating tax' for the State's inability to impose a wholesale tax on such goods was rejected in the same way as in *Armco, Inc.*; Tyler Pipe v. Wash. Dept. of Rev., 483 U.S. 232, 233 (1987).

[2141] The Supreme Court suggested a measure to render the system constitutional: in order to eliminate exposure to the burden of multiple taxation on manufacturing and wholesaling, Washington could provide a credit against Washington manufacturing tax liability for wholesale taxes paid by Washington manufacturers to any State, and a credit against Washington wholesaling tax liability for manufacturing taxes paid to other States by out-of-state manufacturers; Tyler Pipe v. Wash. Dept. of Rev., 483 U.S. 232, 246, 249 (1987). Such a credit system would guarantee that enterprises manufacturing in Washington and selling elsewhere paid only one tax (a wholesaling tax to the State of sale if that State imposed such a tax, or a manufacturing tax if it did not). At the same time, the system would guarantee that out-of-state manufacturers selling in Washington paid only one tax (a manufacturing tax to the State of manufacture if that State imposed such a tax, or a wholesaling tax to Washington if it did not). Finally, the wholly intrastate enterprise would remain in the same position as it was under Washington's existing system as such an enterprise would receive a credit against its manufacturing tax for the wholesale tax it paid. That credit would have the same effect as the existing exemption from manufacturing tax as the manufacturing and wholesaling tax were imposed at the same rates.

Tyler Pipe is of major importance, as it declared a measure to be in violation of the Commerce Clause not because it discriminated by treating interstate business less favourably, but rather because the measure, judged by the criterion of internal consistency, exposed the interstate taxpayer to the burden of multiple taxation[2142]. As a result, the Court makes the link between the internal consistency test and the multiple burden doctrine. It is important to note that the latter doctrine is not directly related to the concept of non-discrimination, but rather shares its *raison d'être* with this concept: both the multiple burden doctrine and the non-discrimination concept are aimed at preserving the internal market by removing obstacles to interstate business. The non-discrimination principle does so by barring States from treating interstate business less favourably than domestic business, whereas the multiple burden doctrine is concerned with situations where, by reason of the interstate nature of the business, the same activities or the same income may be taxed in more than one State. By intertwining the multiple burden doctrine with the internal consistency test, the Supreme Court was able to overview the entire playing field and analyse whether the internal market is upset by a State measure, by assessing whether a generalized application of the measure by all States would lead to multiple tax burdens on interstate enterprises.

II.E. Internal consistency as a Kantian concept: can the measure be universalised?

In 1785, Immanuel Kant published *Grundlegung zur Metaphysik der Sitten* (Fundamental Principles of the Metaphysic of Morals), his first contribution to moral philosophy. This book laid the foundations for his later works *Kritik der praktischen Vernunft* (Critique of Practical Reason; 1788) and *Die Metaphysik der Sitten* (The Metaphysic of Morals; 1797). In *Grundlegung zur Metaphysik der Sitten*, Kant tried to identify the underlying principles of ethics, starting from common reason to identify the supreme unconditional law, then working backwards from there to prove the relevance and weight of the moral law. The centerpiece of this seminal work was the introduction of the 'categorical imperative', the central concept of Kant's moral philosophy.

According to Kant, the supreme moral principle itself must be discovered a priori, through a method of pure moral philosophy. A pure or a priori moral philosophy is a philosophy grounded exclusively on principles that are inherent in and revealed through the operations of reason. According to Kant, the fundamental authoritative normative principle, the principle which tells us how we ought to act, can only be found through an a priori method, as moral commands are unconditional.

Morality presents itself to moral agents as a categorical imperative, and from this imperative are all specific moral duties derived. An imperative (any proposition that declares a certain action to be necessary) may be hypothetical or categorical. A **hypothetical imperative** represents the practical necessity of a possible action as a means to something else that is willed, and therefore would compel action in a given circumstance (if *A*, then *B*, where *A* is a condition or a goal and *B* is an action; e.g. if I wish to quench my thirst, then I must drink something). A **categorical imperative** represents an action as necessary of itself without reference to another end (i.e. as objectively necessary) and is therefore an absolute,

[2142] Tyler Pipe v. Wash. Dept. of Rev., 483 U.S. 232, 248 (1987): *"We conclude that Washington's multiple activities exemption discriminates against interstate commerce as did […] the West Virginia tax that we invalidated in Armco. The current B & O tax exposes manufacturing or selling activity outside the State to a multiple burden from which only the activity of manufacturing in-state and selling in-state is exempt. The fact that the B & O tax has the advantage of appearing nondiscriminatory, does not save it from invalidation."*

unconditional requirement that exerts its authority in all circumstances. The first, and best known, formulation of the categorical imperative is the formula of universal law, which commands, *"act only in accordance with that maxim through which you can at the same time will that it should become a universal law"*[2143].

The categorical imperative is somewhat similar, but far from identical, to the ethic of reciprocity (or the 'Golden Rule'). The ethic of reciprocity is a fundamental moral value in a multitude of cultures[2144], which states that *"one must treat others as one would like to be treated"*. The standard by which to judge the morality of actions is thus judged by the reciprocal desirability thereof, i.e. treatment of others is morally sound if we want to be treated the same way[2145]. Kant himself has pointed out the weakness in this rule, by noting that it is not sensitive to differences of situation. In that respect, Kant gave the famous example of a criminal, who can appeal to the ethic of reciprocity and ask the judge to release him: the judge would not want anyone else to send him to prison, so he should not do so to others[2146].

[2143] Kant gives the following example: *"May I when in distress make a promise with the intention not to keep it?"* The deceitful promisor cannot will that his act is universalized, i.e. that everyone be permitted to promise with the intention not to keep it, otherwise there would be no functioning institution of promising. In order for his promise to attain its objective, the promisor must indeed will there to be a functioning institution of promise: *"while I can will the lie, I can by no means will that lying should be a universal law. For with such a law there would be no promises at all, since it would be in vain to allege my intention in regard to my future actions to those who would not believe this allegation […]. Hence my maxim, as soon as it should be made a universal law, would necessarily destroy itself"*. Another well-known example is the issue of suicide: can the maxim of such an action become a universal law? *"[The] maxim is: 'From self-love I adopt it as a principle to shorten my life when its longer duration is likely to bring more evil than satisfaction.' It is asked then simply whether this principle founded on self-love can become a universal law of nature. Now we see at once that a system of nature of which it should be a law to destroy life by means of the very feeling whose special nature it is to impel to the improvement of life would contradict itself and, therefore, could not exist as a system of nature; hence that maxim cannot possibly exist as a universal law"* (I. KANT, *Fundamental Principles of the Metaphysics of Morals (translated by T.K. ABBOTT)*, New York, Liberal Arts Press, 1949, 30-31).

[2144] E.g. CONFUSIUS, *Analects*, XV:23: *"Do not do unto others what you do not want others to do unto you"*. Similarly, Thales of Miletus held that we should *"never do ourselves what we blame in others"*, DIOGENES LAERTIUS, *The Lives and Opinions of Eminent Philosophers (Translated by C.D. Yonge)*, London, George Bell & Sons, 1895, I, 36. See also LUKE, 6:31 (King James), *"And as ye would that men should do to you, do ye also to them likewise"*and THOMAS HOBBES in *Leviathan*, XV, 35: *"Do not that to another, which thou wouldest not have done to thy selfe"*. Several of these formulations are actually the negative expression of the Golden Rule (i.e. *"do not treat others as you would not like to be treated"*), which is sometimes called the Silver Rule. The differences between both rules will not be discussed here.

[2145] The difference between reciprocity and non-discrimination in tax matters has been discussed in Part II, 2.B.VII. In its basic conception, reciprocity indicates that State A's obligations *vis-à-vis* State B nationals are measured by State B's treatment of State A nationals. Thus, the object of comparison for a State B national who is subject to State A taxation, is a State A national subject to State B taxation. Under the non-discrimination principle, by contrast, the object of comparison for a State B national subject to State A taxation, is a State A national subject to State A taxation. Of course, one could argue that the 'ethical' reciprocity principle (*"one must treat others as one would like to be treated"*) is more in line with the non-discrimination principle in tax matters than with the reciprocity principle underlying most tax treaties. Indeed, State B 'would like' State A to treat State B nationals in the best possible manner, and perhaps State A's treatment of State A nationals is better than State B's treatment of State A nationals. This, however, is an issue of semantics, which I will not dwell on here.

[2146] I. KANT, *Fundamental Principles of the Metaphysics of Morals (translated by T.K. ABBOTT)*, New York, Liberal Arts Press, 1949, 48: *"Let it not be thought that the common 'quod tibi non vis fieri, etc.' could serve here as the rule or principle. For it is only a deduction from the former* [i.e. from the categorical imperative; N.B], *though with several limitations; it cannot be a universal law, for it does not contain the principle of duties to oneself, nor of the duties of benevolence to others […], nor finally that of duties of strict obligation to one another, for on this principle the criminal might argue against the judge who punishes him, and so on."* Strictly speaking, Kant does not denounce the Golden Rule, nor does he label it as faulty. He merely points out that the reciprocity principle cannot fulfill the function of the categorical imperative (obviously, Kant refers to the Silver

While the ECJ's discrimination test can be described as an application of the traditional Aristotelian concept of equality (see supra), the Supreme Court's internal consistency doctrine can be analysed as a judicial application of Kant's categorical imperative. The compatibility of a State measure with the internal market is not tested by finding a comparable internal taxpayer and then analysing whether the interstate taxpayer is treated less favourably, but rather by asking what would happen if all States applied the measure[2147]. Thus, the limits of a State's taxing power are not defined by reference to non-discriminatory treatment of cross-border activities, but rather by surveying the entire internal market and assessing whether the measure would impede cross-border activity if it were generally applied, if it would "become a universal law". Such an approach inherently takes into consideration the needs of the internal market as a whole, by starting from a survey of the entire playing field. Furthermore, as will become apparent below, this approach renders the internal market compatibility-analysis less complex in certain cases. It would therefore be interesting to compare the internal consistency standard with the ECJ's standard, in order to verify whether certain systemic issues of the ECJ's analysis might be remedied by incorporating elements of the internal consistency test.

In particular, the analytical tool offered by the internal consistency test might prove to be helpful in distinguishing cases of discrimination from disparities, as it allows to verify with certainty whether obstacles to the Internal Market are due to one State's tax regime, rather than due to the interaction between different States' regimes. Clearly, internal consistency should not be seen as replacing the test currently applied by the ECJ. Instead, it is an addition to that test, intended to serve a specific purpose, namely to determine whether the issue under scrutiny is one of discrimination or disparity[2148].

> It should be pointed out at this stage that the references to Aristotelian and Kantian ethics are merely intended to clarify the distinction between the traditional conception of non-discrimination as used in Art. 24 OECD MC and the mechanism of internal consistency as it has been developed by the Supreme Court. The purpose of these references, which are thus mainly didactical in nature, is only to show that different formulations are possible as regards the conduct to which States should adhere. In particular, there are certain fundamental principles that prescribe how individuals should conduct themselves in order not to harm the interests of society. In the same way, there are fundamental principles that prescribe how States are to conduct themselves in order not to harm the interests of the internationals community as a whole. The principle of non-discrimination is such a fundamental principle.

Rule and not to the Golden Rule as such, but it should be borne in mind that the negative form of the reciprocity principle was in common use in German moral philosophy in Kant's time, most notably in the work of Christian Thomasius).

[2147] It has been suggested that the concept of fiscal cohesion can also be interpreted as an expression of the categorical imperative. Assuming that all Member States have the same tax system as the system at issue, if in such a situation there would be no discrimination of cross-border activities as compared to domestic activities, the system at issue would be perfectly 'coherent' (see A. CORDEWENER, M. DAHLBERG, P. PISTONE, E. REIMER and C. ROMANO, "The tax treatment of foreign losses: Ritter, M & S and the way ahead (part two)", *European Taxation* 2004, 222). This interpretation of cohesion, which is quite broad, will not be addressed here.

[2148] The internal consistency test has drawn severe criticism in legal literature, mainly because it yields false positives, i.e. indiciations that a tax discriminates, while, in fact, no discrimination exists. When a tax fails the test, it is only established that there is a **theoretical** risk of multiple taxation. It is possible that there is no disadvantage in practice (e.g. M. MOSLEY, "The path out of the quagmire: a better standard for assessing State and local taxes under the negative Commerce Clause", *Tax Lawyer* 2005, 731). For that reason, the internal consistency test should not be seen as the sole deciding factor when determining whether a given tax rule gives rise to discrimination.

> The same is true in tax matters: different norms require States to refrain from treating domestic situations more favourably than cross-border situations (for instance if the taxpayer is a foreign national, if the taxpayer exercises an activity abroad, etc.). As this study has demonstrated, however, it is very hard to formulate an abstract non-discrimination standard which provides a satisfactory solution in any given situation. For that reason, it is thought desirable to consider whether there are other standards, apart from the traditional Aristotelian understanding of non-discrimination, that may improve the analysis.

C. ICT as a tool for identifying disparities

In this section, the internal consistency test will be applied to a number of cases decided by the ECJ which all have in common that the complexity of the factual situation made it difficult for the ECJ to determine with certainty whether the disadvantage at issue was due to the tax system of one Member State or due to the interplay between the tax systems of different Member States. It has been argued in legal literature that applying the internal consistency test can simplify this analysis by disregarding the interplay between different legal systems[2149].

However, it should be pointed out immediately that ICT cannot replace the current non-discrimination standard applied by the ECJ. As discussed at length earlier, the concept of comparability (which is of little importance in ICT) is inherent in the principle of non-discrimination, on which the fundamental freedoms are based. Additionally, it is essential that Member States retain the possibility to justify measures that have been found to infringe EU law, by advancing valid grounds of public interest.

Instead, ICT could be applied as a preliminary question, before the current non-discrimination standard is applied. So the first question to be asked is: was the disadvantage at issue caused by the interplay of different legal systems (disparity) or was it due to one Member State's legal system. In the former case, the issue can be discarded because it goes beyond the fundamental freedoms' scope of application. In the latter case, the traditional non-discrimination analysis should be applied in order to verify whether that Member State's legal system is discriminatory. Clearly, distinguishing between discrimination and disparities is of the utmost importance. On the one hand, deciding that a measure is discriminatory when it is due to a disparity would incorrectly encroach upon the Member States' tax sovereignty. On the other hand, deciding that a measure is due to a disparity when it constitutes discrimination would mean that the Court fails to protect the taxpayers' freedoms.

In order to illustrate the application of ICT, consider the following simple example. State A taxes both residents and non-residents at a uniform rate of 10%. State B taxes residents at 10% and non-residents at 40%. A State A resident earns 10,000 in State A and 10,000 in State

[2149] R. MASON, "Made in America for European tax: the internal consistency test", *Boston College Law Review* 2008, 1277; R. MASON, "A theory of tax discrimination", *Jean Monnet Working Paper 09/06*, http://centers.law.nyu.edu/jeanmonnet/papers/06/060901.html; M. CARRIL, "National tax sovereignty and EC fundamental freedoms: the impact of tax obstacles on the internal market", *Intertax* 2010, 112. Similarly, P. WATTEL, "Progressive taxation of non-residents and intra-EC allocation of personal tax allowances: why Schumacker, Asscher, Gilly and Gschwind do not suffice", *European Taxation* 2000, 219: *"the essence of the problem [in Gilly] is not the result of a disparity […]. Even if the tax systems were fully harmonized (no disparities), the tax disadvantage would continue to exist"*.

B. Accordingly, that taxpayer pays 1,000 taxes in State A and 4,000, resulting in a total tax burden of 5,000. In contrast, a State B resident earning 10,000 in State A and 10,000 in State B would have a total tax burden of 2,000 (1,000 in State A + 1,000 in State B).

Applying ICT to this situation would mean that State B's tax regime is 'universalised', that is to say, both State A and State B would apply State B's tax regime. In that case, the State A resident would still pay 1,000 in State A (being a resident) and 4,000 in State B (being a non-resident). Consequently, the disadvantage would not be removed after universal application of the tax system at issue. ICT thus gives a fairly simple tool to conclude that the measure is not due to a disparity, but due to State B's tax system. The non-discrimination analysis will subsequently determine whether that State's tax system gives rise to discrimination.

Now consider the situation where State A taxes both residents and non-residents at a uniform rate of 10%, while State B taxes both residents and non-residents at a uniform rate of 40%. The taxpayer, a State A resident, earns 10,000 in State A and and 10,000 in State B. Accordingly, that taxpayer pays 1,000 taxes in State A and 4,000, resulting in a total tax burden of 5,000. In contrast, a State A resident earning 20,000 in State A would have a total tax burden of 2,000.

Is the disadvantage incurred by the first taxpayer due to discrimination against cross-border activities? Applying ICT reveals that it is not. If State A's regime is universalised, both State A and State B would apply the uniform rate of 10%. Consequently, a State A taxpayer earning 10,000 in State A and 10,000 in State B would have a total tax burden of 2,000. Since the disadvantage disappears after universally applying the contested measure, it can be concluded that it was due to a disparity. For instance, if the issue in the *Gilly* case pertaining to the credit mechanism (see 2.E.II.C.a) is analysed under ICT, it is clear that the ECJ correctly considered the disadvantage to be the result of a disparity. By verifying what would happen if the other Member State applied the contested measure (i.e. the French regime), the situation in the work State (Germany) is taken out of the equation. If Germany were to apply the exact same system as France, the tax rates in both States would be identical. Under that hypothesis, the credit granted by France would be equal to the amount of tax levied in Germany. Under that hypothesis, the disadvantage in question disappears, which means that it is caused by a disparity.

The underlying idea of this analysis is that, since disparities are the result of differences in the Member States' tax systems, there would be no disparities if all Member States' tax systems were harmonized. So if the disadvantage in question disappears after hypothetically assuming that every Member State applies the measure in question, it can be concluded that that disadvantage is due to a disparity. Conversely, if the disadvantage remains after applying ICT, it can be concluded that the disadvantage is not due to a disparity, which means that the Court has to determine whether there is discrimination.

1. De Groot

The *De Groot* case, which was discussed in 2.E.1.A.b.1.a.6, has been the subject of severe criticism in legal writing[2150]. Apparently, it was felt that the Court erred in deciding that the Dutch rules at issue in that case were discriminatory. I share that criticism. As an analysis

[2150] E.g. B. TERRA and P. WATTEL, o.c., 75 and 804-805; N. MATTSSON, "Does the European Court of Justice understand the policy behind tax benefits based on personal and family circumstances?", *European Taxation* 2003, 193-194.

under ICT will reveal, the disadvantage suffered by the taxpayer in *De Groot* was not due to discrimination but due to a disparity. Most likely, the Court reached a different conclusion because of the complexity of the facts and because of its desire to ensure that taxpayers always receive personal benefits somewhere (the 'always somewhere' approach, which has been criticised earlier).

If all States involved in the *De Groot* case applied the Dutch rules, the result would be the following. As explained earlier, the Dutch rules at issue in *De Groot* only granted personal benefits to residents in proportion to their Dutch-sourced income. Non-residents were also entitled to those personal benefits in the Netherlands[2151]. Applying ICT means that all States involved applied the Dutch rules, that is to say, that all States involved granted personal allowances to both residents and non-residents in proportion to their income in their territory. So Germany would then also grant personal allowances to Mr De Groot, in proportion to his German-sourced income. In total, therefore, he would receive a full personal allowance in all the States combined.

Of course, it is possible that different Member States grant different benefits (e.g. a higher tax-free allowance in State A than in State B, or no deduction for medical expenses in one State). But that is not the point here. What ICT demonstrates is that the Dutch system is internally consistent, meaning that there are no inherent flaws giving rise to a discriminatory distinction. But if the interaction of that system in practice means that a taxpayer working abroad does not receive the exact same personal tax benefits as a taxpayer working at home, that does not constitute discrimination. Rather, that is the result of the different policy choices made by the different Member States (e.g. the amount of the tax-free allowance). Even if all Member States applied an internally consistent rule (e.g. a pro rate grant of personal benefits), it would still be possible that a taxpayer with cross-border income receives greater or smaller personal benefits than he would receive in a purely domestic situation. Such differences are due to the unharmonized nature of the different legal systems and, therefore, due to a disparity. And that is precisely what ICT demonstrates here: the fact that the disadvantage disappears when the Dutch rule is universally applied means that the disadvantage suffered by Mr De Groot was not due to discriminatory legislation in the Netherlands but due to the friction between different legal systems[2152].

The reason is that ICT looks at both the residence rules and the source rules of the State whose legislation is being scrutinized. In *De Groot*, that meant that both the Dutch residence rules and the Dutch source rules were applied to the taxpayer. And since the issue was precisely that he incurred a disadvantage because of the interaction between the Dutch residence rules (which granted a proportional benefit) and the German source rules (which denied the benefit altogether), ICT makes it possible to consider the Dutch rules in isolation, without interference from the German rules. Ultimately, that is the benefit of ICT as compared to the Court's traditional analysis: it allows for a simpler analysis, where only one

---

[2151] P. WATTEL, "Progressive taxation of non-residents and intra-EC allocation of personal tax allowances: why Schumacker, Asscher, Gilly and Gschwind do not suffice", *European Taxation* 2000, 215. In fact, the Netherlands granted the full benefits to non-residents, which goes beyond what is required by the non-discrimination rule. As explained earlier, Member States act in conformity with EU Law if they restrict benefits on a pro rata basis to the amount of income earned in their territory. For the sake of the example, it will be assumed here that the Netherlands treated residents and non-residents the same and granted them both personal benefits on a pro rata basis. The fact that non-residents could be better off than residents under the Dutch rules (reverse discrimination) will not be addressed in detail here. As pointed out earlier, EU law generally does not preclude Member States from treating non-residents better than residents.

[2152] R. MASON, "A theory of tax discrimination", *Jean Monnet Working Paper 09/06*, 36-37.

tax system is considered at a time, without any distraction from other Member States' residence or source rules[2153].

2. Manninen

As in *De Groot,* the interaction of the different legal systems at issue in *Manninen* means that there may be some debate as to whether the Court's conclusion was correct. Here too, ICT might prove helpful in determining whether the disadvantage was due to a disparity.

As explained in 2.E.I.A.b.6.b.3, *Manninen* concerned the Finnish tax regime on inbound dividends. Under that regime, domestic dividends and inbound dividends were subject to a uniform rate, but resident shareholders were only entitled to an imputation credit for domestic dividends. The ECJ held that the Finnish regime was discriminatory because both domestic dividends and inbound dividends were susceptible to double taxation.

If the Finnish rule were universally applied, shareholders of domestic companies would always receive the imputation credit, while shareholders of foreign companies would never receive the credit. Consequently, the complaining taxpayer would still be faced with the same disadvantage as compared to a resident shareholder receiving domestic dividends. Since the disadvantage does not disappear after universal application of the Finnish rule, it cannot be said that the disadvantage suffered by the taxpayer was due to the interaction between Finnish and Swedish law. Instead, the disadvantage was due to a characteristic of the Finnish regime. Whether that characteristic constitutes discrimination should be analysed under the Court's traditional analysis[2154].

So the ICT analysis confirms that the ECJ was correct in deciding that the disadvantage was not due to a disparity. By excluding the Swedish regime from this stage of the analysis, ICT demonstrates that the Finnish rules were internally inconsistent, irrespective of the effect of the Swedish rules.

3. Schempp

In *Schempp,* which was discussed in 2.E.II.C.c, the ECJ held that the disadvantage incurred by Mr Schempp was due to a disparity. In particular, the Court decided that the unability to deduct the maintenance payment in Germany was due to the fact that the tax system applicable to those payments in Austria, his former spouse's State of residence, differed from that applied in Germany. If his former spouse would reside in a Member State where maintenance payments are taxed, the German resident taxpayer would have been entitled to deduct the payments.

As pointed out earlier, it is not very obvious which parts of the Court's analysis are concerned with the disparity-issue and which parts are concerned with discrimination. ICT might clarify the analysis. Assume that every Member State applied the German regime. In that case, Austria would include the maintenance payment in the former spouse's taxable income. However, she would not pay any tax on that payment because her income would not exceed the tax-free threshold. Since the payment was made to a non-resident, Mr Schempp can only deduct if he can provide the German tax authorities with a certificate proving taxation in

[2153] R. MASON, *o.c.*, 39.
[2154] R. MASON, "Made in America for European tax: the internal consistency test", *Boston College Law Review* 2008, 1314-1315.

Austria. However, because he would be unable to do so, the deduction would be denied. So the disadvantage remains even after universal application of the German rules, which means that the disadvantage was not due to a disparity[2155].

I have already argued in 2.E.II.C.c that the German requirement of a certificate proving actual taxation in the hands of the recipient seems to constitute discrimination. Of course, it is possible that this discrimination is justified, for instance by the need to prevent tax avoidance. On the other hand, it is also clear that the discrimination would be removed if Germany also required proof that payments made to German residents are actually taxed in the hands of the recipient. In that case, the German rule would be perfectly neutral[2156].

4. Futura

As discussed earlier, the part of the *Futura* decision concerning the accouning obligations imposed by Luxembourg is a good example of a restriction analysis. If ICT is applied to the rules at issue in that case, the result would be the following. Universalising the Luxembourg rules would mean that all Member States would require non-resident taxpayers with a PE in their territory to keep accounts complying with their accounting rules in order to carry forward losses. At the same time, all Member States would also require their resident taxpayers to keep such accounts in order to carry forward losses. So the administrative burden of a taxpayer engaged in cross-border activity would multiply along with the number of PE's he has in different Member States. Clearly, the disadvantage would not disappear, meaning that there is no disparity. Consequently, in order to verify whether the Luxembourg rule is compatible with the fundamental freedoms, the traditional non-discrimination test should be applied.

5. Renneberg

In *Renneberg*, the facts of which have been set out in 2.E.I.A.b.1.b.3, the argument was raised that the disadvantage incurred by the taxpayer was due to a disparity and not due to discrimination introduced by the Dutch measure at issue. According to the Dutch government, the disparity was caused by the fact that the Dutch tax system allowed deduction of mortgage interest from work-related income while the Belgian tax system did not. Under Belgian tax law, mortgage interest could never be set off against income other than income from immovable property. Thus, even if the person concerned had received work-related income in Belgium, the negative balance of mortgage interest could not be deducted from that income. Under this reasoning, the disadvantage was merely due to the fact that the Belgian tax system allowed less scope for deduction of mortgage interest than the Dutch system. Therefore, the disadvantage incurred by the taxpayer was the consequence of the transfer of his residence to Belgium.

The ECJ dismissed this argument and observed that even if Belgium allowed the losses at issue to be taken into account for determining the taxable base of its residents, a taxpayer in a situation such as that of Mr Renneberg, who receives all or almost all of his income in the Netherlands, would be unable to take advantage thereof[2157]. In fact, that is an application of ICT as it has been described above. The Court verifies what would happen if Belgium also applied the challenged measure. More specifically, if Belgium applied the same tax system as

[2155] R. MASON, "A theory of tax discrimination", *Jean Monnet Working Paper 09/06*, 48-49.
[2156] R. MASON, "A theory of tax discrimination", *Jean Monnet Working Paper 09/06*, 49.
[2157] C-527/06, *Renneberg*, § 75.

the Netherlands, Belgium would also allow its residents to deduct negative income from immovable property from other items of income. Under that hypothesis, a Belgian resident with negative income from a dwelling located in Belgium and his entire employment income arising in the Netherlands would still be unable to deduct the negative income anywhere. Not in the Netherlands, because only residents are entitled to deduct, and not in Belgium either, because he does not have any positive income there[2158]. Since the disadvantage would not disappear if the challenged measure is universally applied, it is not due to a disparity.

D. Limitations of ICT

1. MFN issues

The brief overview given above suggests that ICT is a helpful tool for determining whether a disadvantage is due to a disparity or not. However, there are some important limitations to this test. First of all, it is difficult to apply ICT to cases where a Member States prefers a specific category of non-residents over another category of non-residents, generally in a tax treaty (i.e. MFN cases). The problem is that the rule at issue in such cases is difficult to universalise. Indeed, consider that State A grants specific benefits to State B residents in a tax treaty, but not to State C residents. How can that distinction be universalised in State B or in State C?[2159] In practice, this limitation would not have important repercussions on the ECJ's case law because the Court has been applied a very restrictive comparability-test in situations where tax treaties are involved (see 2.E.I.A.b.9). Nevertheless, this difficulty illustrates that ICT has important shortcomings as a conceptual framework for testing the internal market conformity of direct tax measures.

2. False disparities

The most important limitation of ICT is that it sometimes leads to the conclusion that a disadvantage is due to a disparity while, in reality, it is due to discrimination ('false disparities'). Consider the following example[2160]. State A taxes residents and non-residents at a uniform rate of 40%. State B taxes residents at 10% and non-residents at 40%. A State A resident earning 10,000 in State A and 10,000 in State B pays 4,000 tax in A and 4,000 in B, resulting in an overall tax burden of 8,000. In contrast, a State B national earning 10,000 in State A and 10,000 in State B pays 4,000 in State A and 1,000 in State B, resulting in an overall tax burden of 5,000. Clearly, the disadvantage incurred by the State A resident is due to the fact that State B discriminates on the basis of residence by granting lower tax rates to its own residents.

Applying ICT, all States involved would apply State B's tax regime. So a State A resident earning 10,000 in State A and 10,000 in State B would pay 1,000 tax in State A and 4,000 in State B, resulting in an overall tax burden of 5,000. So the disadvantage as compared to the State B resident would disappear. In other words, applying ICT suggests that the disadvantage

---

2158 Similarly, S. DOUMA, "Noot onder Hoge Raad 22 december 2006", *FED Fiscaal Weekblad* 2007/6, point 12: *"ook indien België dezelfde belastingwetgeving als Nederland zou kennen, zou de nadelige behandeling van belanghebbende door Nederland – geen aftrek van hypotheekrente op zijn Nederlandse arbeidsinkomen – geheel in stand blijven."*

2159 R. MASON, "Made in America for European tax: the internal consistency test", *Boston College Law Review* 2008, 1323.

2160 The example is similar to the one given above, but now State A's uniform rate is identical to State B's rate for non-residents, while it was identical to State B's rate for residents in the first example.

incurred by the State A resident is the result of a disparity while it is clearly due to State B's discriminatory legislation.

Similarly, consider the *De Groot* case, discussed above, but from the perspective of Germany's legislation. In other words, assume that Mr De Groot sued Germany instead of the Netherlands. Further, assume that that Germany granted full personal benefits only to residents and that the Dutch regime remained the same as in *De Groot*. In that case, if Mr De Groot would earn 50% of his income in the Netherlands and 50% in Germany, he would receive half the personal benefits in the Netherlands, but no benefits at all in Germany.

If the German rule is universalised, Mr De Groot would receive the full benefit in the Netherlands (since the German rule, which grants full benefits only to residents, also applies hypothetically in the Netherlands). As a result, the disadvantage he incurred as compared to a taxpayer who is only active in the Netherlands would disappear. Once again, this suggests that that disadvantage is due to a disparity. But it is clear that it is actually due to Germany's decision to grant full benefits only to residents and no benefits at all to non-residents. It should therefore be assessed whether that distinction is discriminatory, taking into account in particular the question whether residents and non-residents are comparable as regards the benefits at issue.

Finally, assume that the Finnish credit at issue in *Manninen* was also granted to non-resident shareholders. That is to say, assume that Finland taxes resident companies' profits at a rate of 29% and also taxes shareholders receiving dividends at a rate of 29%. In order to avoid double taxation on dividends, Finland grants a credit equal to 29/71 of the amount of the dividends received from a resident company and this credit is granted both to resident shareholders and to non-resident shareholders. A resident shareholder receiving dividends from a Swedish company would not be entitled to the credit, since the credit is restricted to dividends received from resident companies.

If the Finnish measure is universalised, Sweden would apply the Finnish rules, i.e. Sweden would tax the Swedish company's profits at a rate of 29% and grant the Finnish shareholder a credit equal to 29/71 of the amount of the dividends received. Accordingly, the corporation tax imposed in Sweden would be effectively removed by granting a corresponding tax credit also to non-resident shareholders. As a result, the disadvantage as compared to a Finnish resident receiving dividends from a Finnish company would disappear, which suggests that the disadvantage is due to a disparity[2161]. It is clear, however, that in reality the disadvantage is due to Finland's decision to grant tax credits solely in respect of dividends received from Finnish companies. But that distinction is obfuscated in the ICT-test because Finland does not distinguish in another area, namely between resident and non-resident shareholders.

3. Insufficient conceptual strength

A final limitation is that ICT is difficult to apply in complex cases such as *Kerckhaert-Morres*, where there is a subtle interplay between discrimination, restriction and disparity. As I have argued in 2.E.I.A.b.6.b.5, the Court applied both a discrimination analysis and a restriction analysis in that case. The reason is that the Belgian measure at issue did not make any distinction between the domestic situation and a cross-border situation. Therefore, it was necessary for the Court to consider (1) whether that identical treatment was nevertheless

[2161] See also J. ENGLISCH, "Taxation of cross-border dividends and EC fundamental freedoms", *Intertax* 2010, 210.

discriminatory because the situations were incomparable and (2) if not, whether that identical treatment gave rise to a non-discriminatory restriction. With respect to the first of these issues, the Court held that there was no discrimination because the situations were comparable. With respect to the second issue, the Court held that there was no restriction because the double layer of taxation was due a disparity.

When ICT is applied to the facts of *Kerckhaert-Morres*, the Belgian regime is universalised: Member States levy withholding tax on outbound dividends and subject inbound dividends to tax at a uniform rate without granting relief for foreign source tax. Consequently, the disadvantage would not disappear, which suggestst that the Belgian regime is to blame for that disadvantage. To some extent, this is true: by subjecting inbound dividends and domestic dividends to the same regime, Belgium created a disadvantage for cross-border investors. By applying its traditional discrimination-analysis, the Court found that the fundamental freedoms had not been infringed[2162].

However, the fact that the disadvantage does not disappear also suggests that there is no disparity, which is not entirely true. The Court correctly decided that the double layer of taxation was due to a disparity, i.e. due to the co-existence of the French source rules and the Belgian residence rules. Accordingly, ICT does not only result in false disparities (see supra: ICT may suggest that a disadvantage is due to a disparity, while, in reality, it is caused by discrimination), but also in the opposite. More specifically, ICT may suggest that a disadvantage is entirely due to one regime and thus overlook that it is also partly caused by the interplay of the different regimes.

E. Conclusion

Even though ICT is helpful in a number of cases, its limitations ultimately outweigh its usefulness. Since it results in errors in both directions (i.e. both false indications that there is a disparity and false indications that there is no disparity), it does not seem to be a helpful tool in analysing direct tax cases in the European context.

ICT does not offer solutions that the traditional non-discrimination analysis cannot provide. But the problem is that the traditional analysis is not always applied in an analytically consistent manner. By inverting steps of the analysis, or by skipping certain steps altogether, the ECJ has given a number of decisions that are confusing for taxpayers, commentators and sometimes even for the Court itself. If the Court would strictly distinguish the different steps of the analysis, most (if not all) problems would be resolved appropriately.

To take the example of *De Groot*: an appropriate discrimination-analysis would ask (1) whether the domestic measure under scrutiny makes a distinction (2) between two situations that are comparable (3) resulting in a disadvantage for the protected category of taxpayers[2163]? The question that seems to have been overlooked by the ECJ in *De Groot* was whether the disadvantage suffered by Mr De Groot was **due to** the distinction made by the Dutch rules at issue (which is an aspect of the third question). And a thorough analysis reveals that the Dutch rules were not to blame for that disadvantage (see supra). Similarly, it is clear that the

[2162] As pointed out in 2.E.I.A.b.6.b.5, the Court's conclusion on that point may be questionable from the perspective of comparability. But that is not the point here. What is at stake is whether ICT simplifies the analysis by clearly distinguishing between discrimination and disparities.
[2163] See the flowchart in Part I, B.II.

disadvantage at issue in *Manninen* was **due to** the Finnish regime under scrutiny: a taxpayer receiving foreign dividends suffered a disadvantage as compared to a taxpayer receiving domestic dividends **because** Finland only granted a credit to the latter taxpayer. Finally, with respect to the two disadvantages at issue in *Schempp* (see 2.E.II.C.c). (1)(a) The disadvantage arising in the situation where Austria does not tax the income while Germany does, is not due to the German regime but due to the sovereign decision of Austria not to tax (i.e. a disparity). (b) However, the disadvantage in the situation where Germany does not tax either (i.e. because the tax-free threshold is not exceeded) is clearly **due to** a distinction made in the German regime. It thus needs to be verified whether the non-taxation in Germany is comparable to the non-taxation in Austria (which, according to the Court, is not the case). (2) Secondly, the disadvantage consisting of the requirement of a certificate for cross-border payments is clearly **due to** a distinction made in the German regime.

In conclusion, ICT could be a useful tool in certain instances in order to determine whether the disadvantage suffered by the subject of comparison was due to the measure under scrutiny (by considering whether the rules under scrutiny are internally consistent) but the weaknesses inherent in that approach (see supra) should be kept in mind. Ultimately, ICT cannot replace the traditional discrimination analysis. Applying that traditional analysis in a consistent and theoretically correct manner allows disparities to be discerned from cases of discrimination.

Part IV: Comparison and interaction

1. A comparison of Art. 24 OECD MC and the ECJ's non-discrimination standard

A. Scope of application

Both the standard of Art. 24 OECD MC and the standard underlying the ECJ's case law are based on the same Aristotelian view of non-discrimination: situations that are comparable should be treated equally, and vice versa. Both standards also use the same mechanism in applying this Aristotelian view of non-discrimination. That means, first of all, that situations are considered to be comparable if the relevant characteristics are identical. And the relevance of characteristics is always determined by the measure under scrutiny. Moreover, characteristics which are inherently linked to the comparative attribute are disregarded. Otherwise, the non-discrimination test would be rendered meaningless. Secondly, the existence of a disadvantage is generally considered in an isolated manner. As a result, counterbalancing advantages or disadvantages do not remove the disadvantage incurred by the subject of comparison.

Additionally, the finality of both non-discrimination standards is quite similar. The fundamental freedoms are designed to ensure that obstacles to interstate trade are abolished, thereby furthering the economic development of the internal market. Similarly, the non-discrimination provision in tax treaties seeks to remove discriminatory obstacles to trade between the contracting States in order to advance economic development. So it is incorrect to assume that a tax treaty – and the non-discrimination provision in particular – is merely intended to remove double taxation. The purpose of tax treaties is broader, in that they aim to eliminate a number of obstacles to interstate trade, including double taxation and discriminatory tax measures.

Nevertheless, there are some important differences between the standards. The main difference is that Art. 24 OECD MC is very specific in its scope by describing the various instances in which it can be applied (e.g. nationality discrimination, foreign ownership discrimination, etc.), while the European freedoms have been interpreted as precluding any type of discrimination that may impede the development of the internal market.

There are two important aspects that are closely related to this main difference. First, the ECJ has extended the application of its non-discrimination standard to cases where the discrimination is not 'direct' but only 'indirect', i.e. where the measure at issue does not exclusively target the protected category, but mainly affects that category. In contrast, Art. 24 OECD MC has generally remained confined to direct types of discrimination (i.e. direct nationality discrimination under Art. 24(1), direct foreign ownership discrimination under Art. 24(5), etc.). A second aspect is that Art. 24 OECD MC is mainly concerned with discrimination against different types of inbound activity. Whether it concerns discrimination against foreign nationals, against the PE of a non-resident or against foreign-owned enterprises, the focus is always on the investment from foreign persons in a host country being impeded by discriminatory tax treatment. Art. 24(4) can be seen as an exception, in that it concerns a form of outbound activity, namely the discrimination of residents making outbound payments as compared to residents making domestic payments[2164]. In contrast, the standard developed by the ECJ does not distinguish between inbound activity and outbound activity. Impediments against both types of activity are equally detrimental to the development of the internal market. For that reason, the ECJ has also applied its discrimination analysis to cases where a Member State makes a distinction between residents on the basis of the exercise of the fundamental freedoms (see Part III, 2.D.V.C).

Because the non-discrimination standard embodied in the fundamental freedoms has been given such a wide scope of application, the ECJ has developed a number of justification grounds in its case law in order to ensure that certain public policy objectives are safeguarded. That way, the ECJ is able to balance the taxpayers' interest in not being discriminated against and the Member States' public policy interests. This concern is of particular importance in the field of direct taxation, given its sensitive nature and the Member States' retained sovereignty. In contrast, Article 24 OECD MC does not allow States to argue that discriminatory measures are justified on the basis of public policy grounds. Compared to the non-discrimination standard of the European freedoms, Article 24 is thus less flexible, since it is applied in a strictly mechanical way without any consideration for overriding reasons of general interest. In practice, however, this does not seem to give rise to substantial problems, precisely because the scope of Article 24 is so narrowly defined. In other words, because Article 24 has not been given such a wide scope of application as the fundamental freedoms, the need for safety valves – i.e. justification grounds – is not quite as pressing. In this respect, it is useful to recall that national courts do not seem particularly willing to incorporate safety valves in their interpretation of the comparability- and disadvantage-test under Article 24 to compensate for the lack of justification grounds. That may support the idea that the scope of application of Article 24 is sufficiently narrow for the provision to function properly without requiring additional checks and balances.

So at first sight, the general impression is that the non-discrimination standard developed by the ECJ is much broader than the non-discrimination rules provided for in Art. 24 OECD MC. A comparison of the different aspects of the non-discrimination principle (i.e. comparability and disadvantage) and the different types of tax discrimination that have been discussed (discrimination against PEs of non-residents, discrimination against foreign-owned residents, etc.) reveals to what extent the scope of application of both standards differs.

I. Nationality discrimination: a comparison with Art. 24(1)

The most obvious difference between Article 24 OECD MC and the standard applied by the ECJ is that Art. 24 does not include a general prohibition of discrimination against non-residents. As discussed in Part II, 2.B, Art. 24(1) only protects non-nationals from discrimination. The other clauses of Art. 24 offer some protection to non-residents, but only in very specific areas (e.g. non-residents having a PE in the source State). In contrast, the fundamental freedoms have been extended to cover discrimination against non-residents because such discrimination 'mainly' affects non-nationals. As noted in Part I, B.II, interpreting a non-discrimination rule to cover indirect discrimination means that the

[2164] Of course, the deductibility provision could also be seen as complementing the protection offered by Art. 24(5) in that the former protects forms of investments by non-residents that do not give rise to a participation in a resident enterprise. In order to prevent discrimination against such types of foreign investment, Art. 24(4) prohibits the residence State of the payor from applying discriminatory conditions as regards deductibility. Art. 24(2), the provision on stateless persons, is not really aimed at either inbound or outbound activity.

necessary link between the relevant characteristic and the comparative attribute is relaxed. The more 'indirect effect' given to the non-discrimination rule, the sooner a characteristic will be considered to be linked to the comparative attribute (and therefore disregarded, meaning that the situations are comparable).

Apart from that difference in scope, the standards are applied in an identical way. Both under Art. 24(1) and under the fundamental freedoms, the subject of comparison, a non-national, is compared to a taxpayer who is identical in all relevant aspects apart from the comparative attribute[2165]. In this respect, it is interesting that both standards start from the assumption that residents and non-residents are generally incomparable. This results, on the one hand, from the inclusion of the same circumstances-requirement in the text of Art. 24(1) OECD MC and, on the other hand, from the consistent case law to that effect of the ECJ[2166]. The difference between the two standards is that the ECJ has recognized numerous situations where, despite their general incomparability, residents and non-residents are nevertheless comparable (e.g. where a non-resident employee earns (almost) all of his income in the work State or where income-related benefits are concerned). In contrast, the incomparability of residents and non-residents is absolute in the context of Art. 24(1) OECD MC (unless, of course, residence is not a relevant characteristic for the purposes of the domestic measure at issue).

II. Inbound PE cases: a comparison with Art. 24(3)

As noted in Part III, 2.E.I.A.a.1, the ECJ's basic approach in inbound PE cases is that a PE is incomparable to a resident taxpayer, which is arguably an application of the *Schumacker*-incomparability. However, that basic incomparability is generally set aside where the taxation of a specific item of income is concerned (e.g. relief for double taxation of dividends in *Avoir fiscal* and *Saint-Gobain*, interest on a tax refund in *Commerzbank*): in such cases, the comparability is determined by the tax treatment of that income in the source State. If the source State taxes both residents and non-residents in respect of such income, non-residents are comparable to residents with respect to tax benefits relating to that income (which is an application of the ECJ's general approach towards income-related benefits, as set out in *Biehl*-type cases; see Part III, 2.E.I.A.b.2). On the other hand, the basic approach under Article 24(3) OECD MC is that the PE should be seen as a separate entity which is entitled to the same treatment as a resident enterprise carrying on the same activities. This approach should be seen in combination with Art. 7 OECD MC, which entitles the non-resident taxpayer to be treated similarly to a resident competitor when his presence in the source State reaches the PE-threshold. So at first sight, the ECJ's approach seems different from the approach taken under Article 24(3), but that is deceptive. Under both standards, the basic assumption is that residents and non-residents are incomparable. But that incomparability is set aside where income-related benefits are concerned[2167] and the source State taxes the income in question (which, in the context of Art. 7, requires there to be a PE, in which case Art. 24(3) applies). In

[2165] Consider also the definition of nationality as regards legal persons. Art. 3(1)(g) OECD MC defines a national as *"any legal person, partnership or association deriving its status as such from the laws in force in a contracting State"*. Furthermore, even though Article 1 restricts the scope of the OECD MC to residents of the contracting States, Article 24(1) provides that it also applies to persons who are not residents of the contracting States. This is quite similar to the approach taken in Art. 54 TFEU (former Art. 48 EC), which refers to *"companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Union"*.

[2166] C-279/93, *Schumacker*, § 31.

[2167] It should be recalled that person-related benefits are excluded from Article 24(3) OECD MC, see Part II, 2.D.III.D.

that case, both standards protect the non-resident from discrimination as compared to resident competitors. So from that perspective, the approach is the same, it being understood that the ECJ's approach is merely an application of its general case law (*Biehl*), while the approach under Art. 24(3) is determined by the separate entity-approach of Art. 7.

The ECJ first set out its position on inbound PE cases in *Avoir fiscal* (see Part III, 2.E.I.A.a.1). In that case, the ECJ held that the French tax credit which was granted to resident recipients of French-sourced dividends should be extended to the PE which a resident of another Member State has in France. Would that case have been decided differently under Art. 24(3) OECD MC? As argued in Part I, 2.D.III.B.c, domestic tax rules intended to alleviate double taxation on dividends should be extended to PEs on the basis of Art. 24(3). The Commentary is reluctant to take a position for or against extending such benefits, but it should be repeated that the arguments against are quite weak. So *Avoir fiscal* should also have been decided in favour of the taxpayer under Art. 24(3).

The *Commerzbank* decision is particularly interesting from the perspective of the comparison between both standards, because the facts at issue in that case had earlier given rise to a challenge on the basis of the tax treaty PE non-discrimination provision before the U.K. High Court. That Court correctly held that the repayment supplement could not be granted to the PE on the basis of the tax treaty non-discrimination clause, because it was **interest on taxation**, not taxation itself, which was being less favourably levied. Art. 24(3) does not preclude discrimination of PEs as regards formalities connected with the discrimination, as long as this does not result in less favourable taxation. That was the case in *Commerzbank*. Even though there was a formality that was applied less favourably to PEs (the repayment supplement), there was no discrimination since the taxation itself was not less favourable (see Part II, 2.D.III.C.a.2). In contrast, the fundamental freedoms do not distinguish between disadvantages pertaining to the taxation itself and other disadvantages. As soon as the PE of a non-resident is treated less favourably than a resident, there is discrimination (see Part III, 2.E.I.A.a.1.b).

The same position can be taken with respect to the second issue in *Futura*, i.e. the obligation to keep proper accounts. As it concerned a formality connected with the taxation, distinguishing between a resident and the PE of a non-resident in that respect would not constitute discrimination contrary to Art. 24(3). In contrast, the ECJ held that the less favourable application of that formality to the PE of a resident of another Member State infringed the fundamental freedoms.

The first issue in *Futura* was that non-residents carrying on business in Luxembourg through a PE were allowed to deduct losses carried forward from previous years, but only if those losses were 'economically related' to income earned in Luxembourg, i.e. only losses arising from the non-resident's activities in Luxembourg could be carried forward. The ECJ held that this requirement was compatible with the freedom of establishment because it was in accordance with the principle of territoriality. Since non-residents were only taxable in Luxembourg on profits sourced there, it was not incompatible with the fundamental freedoms that only losses connected to the Luxembourg activities can be carried forward. The same result would be reached under Art. 24(3). The Commentary notes that domestic rules concerning loss carry-back or carry-forward should also be applied to PEs of non-residents, but that it is only the loss on the PE's own business activities which qualifies for carry-back or carry-forward[2168]. So here as well, the 'principle of territoriality' is decisive, that is to say, since the non-resident is only taxable in the PE State on income attributable to the PE, it does not constitute discrimination to limit the loss carry-over to the PE's activities.

The issue in *Royal Bank of Scotland* would also be decided identically under Art. 24(3). Applying a higher tax rate to profits of a non-resident's PE than the rate applied to residents is cleary contrary to Art. 24(3) (see Part II, 2.D.III.B.b). A similar issue was discussed in *CLT-UFA*, where the ECJ held that the freedom of establishment precluded a domestic rule that applied a higher tax rate to the profits earned by the PE of a non-resident as compared to the rate applied to profits earned by resident companies if those profits were distributed to the parent company (see Part III, 2.E.I.A.a.1.f and Part III, I.B.c.4). In fact, that is quite comparable to the branch profits tax, discussed in Part II, 2.D.III.B.b, where a State imposes an additional tax (or simply a higher tax rate) on the profits earned by a PE to compensate for the fact that, unlike the situation where the profits are earned by a resident company, there is no subsequent profit distribution that can give rise to taxation in that State. Such an additional tax is incompatible with Art. 24(3)[2169].

With respect to the *Saint Gobain* decision, two situations should be distinguished. As pointed out in Part III, 2.E.I.A.a.1.e, two relief mechanisms were at play in that case. First, the Court held that the credit provided for in German domestic law should also cover the Italian and Austrian dividends. That decision is entirely in line with the practice under Art. 24(3) OECD MC. As discussed in Part II, 2.D.III.B.e, Art. 24(3) requires the PE State to extend its domestic measures for relief from double taxation to the PE which a resident of the other Contracting State has in its territory.

Furthermore, the ECJ held that the second relief mechanism, the exemption provided for in the tax treaties with Switzerland and the U.S., should also be extended to the taxpayer's German PE. Since the Court's decision on that point was based on the assumption that the relief mechanisms in question were granted solely under the tax treaty (see Part III, 2.E.II.C.b), this implies that the fundamental freedoms require tax treaty relief mechanisms to be extended to the PE of a resident of another Member State. In this respect, the Court has distinguished between, on the one hand, elements of a tax treaty that relate to the allocation of taxing powers and, on the other hand, elements of a tax treaty that relate to the exercise of those taxing powers. Such a decision would not be possible under Art. 24(3). As the Commentary observes, for a PE to be entitled to benefits provided for in a treaty between the PE State and a third State, it is necessary that that treaty includes an express provision to that effect[2170]. So the fundamental freedoms are significantly broader than Art. 24(3) OECD MC in this respect.

This comparison shows that the analysis under Art. 24(3) is very similar to the analysis carried out by the ECJ. First of all, the same subject of comparison (a non-resident taxpayer with a PE in the taxing State) and the same object of comparison (a resident of the taxing State) are used. Furthermore, it seems that a number of inbound PE cases decided by the ECJ

[2168] Comm. OECD on Art. 24, para. 40(c).

[2169] As noted in Part III, I.B.c.4, the higher tax rate on PE's in *CLT-UFA* was not intended to compensate for the absence of a subsequent tax on profit distributions. Rather, the higher tax on PEs as compared to resident subsidiaries was explained by the fact that profits distributed by subsidiaries could give rise to double taxation. Nevertheless, the principle remains the same: a disadvantage suffered by the subject of comparison cannot be explained by relying on a counterbalancing advantage or disadvantage.

[2170] Comm. OECD on Art. 24, para. 70. See Part II, 2.D.III.B.e.

would be decided identically under Art. 24(3). Ultimately, however, the protection offered by the ECJ's analysis is broader, in particular with respect to the scope of application. As pointed out above, with respect to *Commerzbank*, Art. 24(3) is only concerned with 'taxation' as such. Additionally, the scope of Art. 24(3) is restricted to business profits attributable to the PE under Art. 7 OECD MC (see Part II, 2.D.III.A), while the non-discrimination standard developed by the ECJ precludes tax discrimination with respect to all types of income. A second aspect where the ECJ's non-discrimination standard offers broader protection is the entitlement to benefits provided for in treaties with third States (see *Saint Gobain*).

III. Outbound payments: comparison with Art. 24(4)

When comparing Art. 24(4) OECD MC with the ECJ's case law, it should be stressed immediately that the former is only concerned with the **deductibility** of outbound payments. For that reason, the mere application of withholding obligations exclusively on outbound payments cannot be said to infringe that provision. In contrast, the ECJ has decided several cases on that issue (see Part III, 2.E.I.A.b.7).

A comparison between Art. 24(4) OECD MC and the ECJ's case law is mainly interesting from the perspective of domestic thin cap rules. The ECJ has had several opportunities to decide on such rules, most notably in *Thin Cap GLO*, *Lankhorst-Hohorst* and *Lammers & Van Cleeff*. In those cases, the ECJ relies on its basic position that the resident subsidiary of a non-resident parent company and the resident subsidiary of a resident parent company are not rendered incomparable merely because of the incomparability at the level of the parent companies. For the situations to be incomparable, a relevant characteristic must differ between them. And, in general, the ECJ does not consider the parent companies' tax position to be a relevant characteristic (see Part III, 2.E.I.A.b.5.c).

As noted in Part II, 2.E.II, it is difficult to take a position on the comparability-test under Art. 24(4) OECD MC because neither the text of the provision, nor the Commentary contains any guidance on how to construct the object of comparison. As a result, there is nothing to prevent, for instance, a non-resident recipient of interest from being compared to a non-exempt resident recipient, which would mean that a domestic rule that distinguishes on the basis of the recipient's tax exempt status gives rise to discrimination. On the other hand, it could also be said that the comparison is with a resident exempt recipient, which would mean that there is no discrimination. As a result, it is difficult to compare the comparability-test used by the ECJ in thin cap-cases to the comparability-test under Art. 24(4). If it is accepted that Art. 24(4) contains an implicit 'same circumstances' test, the comparability-tests would be the same. In both cases, the decisive question would be whether all relevant characteristics are the same among subject and object of comparison. Generally, the non-resident recipient's tax position will not be considered as a relevant characteristic.

The more interesting comparison between these two standards concerns the influence of the arm's length standard. In fact, this is one of the few examples of actual justification grounds under Article 24 OECD MC (see infra, 1.B). As noted in Part II, 2.E.IV, Art. 24(4) does not apply insofar as the domestic measure complies with the arm's length standard as provided for in Arts. 9(1), 11(6) and 12(4) OECD MC. Additionally, because Art. 9(1) is restrictive in nature, it precludes adjustments to an amount greater than the arm's length amount.

Similarly, the ECJ has repeatedly held that the discrimination arising from the application of a domestic thin cap measure may be justified where that measure complies with the arm's length standard. In particular, domestic measures are justified by the need to prevent tax avoidance where they specifically target wholly artificial arrangements which do not reflect economic reality and which are designed to escape the tax normally due on the profits generated by activities carried out on national territory[2171].

By providing that that interest is to be treated as a distribution, thin cap legislation is able to prevent practices the sole purpose of which is to avoid the tax that would normally be payable on profits generated by activities undertaken in the national territory. For that reason, such legislation is an appropriate means of attaining that objective. Moreover, the Court has held that such legislation is not proportionate to that objective if it applies generally to any situation in which the parent company has its seat in another Member State[2172]. In contrast, the domestic measure is proportionate to the objective of preventing tax avoidance where it provides that interest paid by a resident subsidiary to a non-resident parent company is treated as a distribution only if, and insofar as, it exceeds what those companies would have agreed upon on an arm's-length basis. According to the Court, that is an objective element which can be independently verified in order to determine whether the transaction in question represents is a purely artificial arrangement that is solely intended to avoid tax. Moreover, for the measure to be proportionate, the taxpayer must be given an opportunity, without being subject to undue administrative constraints, to provide evidence of any commercial justification that there may have been for that arrangement and the re-characterisation of interest to dividends must be limited to the arm's length amount[2173].

Therefore, the arm's length standard offers a let-out for discrimination under both non-discrimination standards. As to the modalities connected with that justification, the limitation of the adjustment to the arm's length amount is identical in both cases (which should not be surprising since the ECJ's interpretation of the arm's length standard is clearly inspired by Art. 9 OECD MC). But the ECJ goes beyond the conditions imposed by Art. 9 OECD MC and also requires that the taxpayer is given the opportunity to bring forward commercial justifications for deviating from the arm's length standard.

IV. Discrimination on the basis of the parent company's residence: comparison with Art. 24(5)

IV.A. General

The main difference between Art. 24 OECD MC and the ECJ's non-discrimination standard as regards groups of companies is that Art. 24(5) OECD MC only applies to a subsidiary established in one contracting State, the parent company of which is established in the other contracting State. In contrast, the scope of protection offered by the ECJ's non-discrimination standard is broader, as it covers every member of the group. The fundamental freedoms thus protect both the parent company when establishing or investing in the subsidiary's Member State and the subsidiary when establishing itself or receiving investment from the parent

[2171] C-196/04, *Cadbury Schweppes*, § 55.
[2172] C-324/00, *Lankhorst-Hohorst*, § 37.
[2173] C-524/04, *Thin Cap GLO*, § 80-83; C-105/07, *Lammers & Van Cleeff*, § 29-30.

company[2174]. Additionally, Art. 24(5) only covers the situations of direct foreign ownership discrimination, i.e. situations where all relevant characteristics apart from foreign ownership are the same. In contrast, the fundamental freedoms also cover situations where the domestic measure 'mainly' affects foreign-owned enterprises (i.e. indirect foreign ownership discrimination).

Apart from those differences in scope, the standards are applied in the same way. Consequently, the starting point is that a foreign-owned enterprise is compared to a domestically-owned enterprise. Those situations are incomparable if there is a characteristic that is different between them and that characteristic is relevant for the purposes of the domestic measure under scrutiny. Both in *Thin Cap GLO* and in *X and Y*, the ECJ did not accept that the mere fact that the parent company is not a resident (and therefore not subject to tax) is sufficient to render the resident subsidiaries incomparable. In order for that to be the case, the parent company's non-residence (and the resulting non-taxability) would have to be a relevant characteristic for the purposes of the taxation of the resident subsidiary. Similarly, the shareholder's tax position should only be taken into consideration in the comparability-test under Art. 24(5) when it is relevant for the purposes of the taxation of the subject of comparison.

IV.B. Boake Allen – Metallgesellschaft

The *Boake Allen* case, discussed in Part II, 2.F.II.D.d, and the *Metallgesellschaft* case, discussed in Part III, I.A.b.5.a, are particularly interesting in this context because the exact same issue is addressed in these case from the perspective of Art. 24(5) OECD MC in *Boake Allen* and from the perspective of the fundamental freedoms in *Metallgesellschaft*.

In *Boake Allen* as well as in *Metallgesellschaft*, the U.K. government argued that the situation of resident subsidiaries of resident parent companies is not comparable to that of resident subsidiaries of non-resident parent companies. Even though the group income election relieves resident subsidiaries of resident parent companies of the obligation to pay ACT when paying dividends to their parent company, that payment is merely deferred: the parent company is itself required to pay ACT when it makes distributions subject to that tax. The obligation to pay ACT when paying dividends is therefore **transferred** from the subsidiary to the parent company and the subsidiary's exemption from ACT is offset by the parent company's liability to ACT.

The situation is different for resident subsidiaries of non-resident parent companies: if they were able to benefit from the group election regime, no ACT at all would be paid in the U.K. The subsidiary would be exempt from payment of ACT when paying dividends to its parent company, but that exemption would not be offset by any subsequent payment of ACT by the non-resident parent company when it makes distributions, since it is not subject to corporation tax in the U.K. or, therefore, to ACT.

[2174] Compare, for instance, C-200/98, *X AB and Y AB* (see Part III, 2.E.I.A.b.4.b), where the ECJ held that the Swedish regime on intra-group transfers discriminated against resident companies with a non-resident subsidiary, with the decisions of the Swedish Supreme Administrative Court on the same regime under Art. 24(5) (see Part II, 2.F.I.C.d and Part II, 2.F.III.B.c), where it could only be assessed whether resident companies with a non-resident parent company were discriminated against.

In *Metallgesellschaft*, the ECJ dismissed that argument by first pointing out that ACT is not a tax on dividends but rather an advance payment of corporation tax. For that reason, the argument that resident subsidiaries of non-resident parent companies would avoid paying any tax in the U.K. if they were entitled to the election is incorrect. The proportion of income tax that is not paid by the subsidiary in ACT under the election regime is paid later, when the subsidiary's MCT liability falls due. That is the same for resident subsidiaries of resident parent companies and for resident subsidiaries of non-resident parent companies. Ultimately, both types of resident subsidiary would be liable to the same amount of MCT (assuming that their bases of assessment are the same). Consequently, extending the election regime to resident subsidiaries of non-resident parent companies would do no more than allow them to retain the sums which would otherwise be payable by way of ACT until the time their MCT liability falls due, that is to say, they would enjoy the same cashflow advantage as resident subsidiaries of resident parent companies.

The fact that a non-resident parent company, unlike a resident parent company, will not be subject to ACT when it pays out dividends does not affect that conclusion. According to the ECJ, the fact that a non-resident parent company is not liable to ACT is simply because it is not liable to corporation tax in the U.K. The ECJ thus concludes that *"logic therefore requires that a company should not have to make advance payment of a tax to which it will never be liable."*

In *Boake Allen*, however, the House of Lords accepted the tax authorities' argument on the grounds that the freedom of establishment has a different purpose from the non-discrimination provision in a tax treaty. The freedom of establishment is the freedom of a resident of a Member State to establish itself in another Member State, for instance by establishing a subsidiary. A resident's freedom of establishment is thus infringed when the host State imposes restrictions on such a subsidiary. Accordingly, discrimination against the group as a whole infringes the parent company's freedom of establishment. If a group with a U.K. parent company has a cashflow advantage which a group with a parent company in another Member State does not enjoy, the latter parent's freedom of establishment has been restricted. In *Boake Allen*, there was a restriction in the host State (the U.K.) since that State allowed resident subsidiaries of resident parent companies to make the election, while resident subsidiaries of non-resident parent companies were unable to do so. In contrast, a tax treaty does not give residents of a contracting State a right of establishment in the other contracting State. The equality it ensures is only that any company owned by a resident of a contracting State will not be subject in the other contracting State to taxation which discriminates on the ground of its foreign control. According to the House of Lords, the denial of the right of election was not on the ground of the company's foreign control but on the ground that it could not be applied to a case where the parent company is not liable to ACT.

I disagree with the distinction made by the House of Lords, i.e. that the ECJ decided *Metallgesellschaft* on the basis that discrimination against the group as a whole constitutes a restriction on the parent company's freedom of establishment. As pointed out above, the ECJ does **not** look at the treatment of the group as a whole. It only looks at the cashflow disadvantage for the subsidiary. Because the election regime is denied where the parent is a non-resident, the resident subsidiary suffers a cashflow disadvantage as compared to a resident subsidiary of a resident parent. As a result, there is discrimination against the foreign-owned subsidiary. It is that cash-flow disadvantage that constitutes the restriction on the parent company's freedom of establishment. It is true that the group election regime **also** leads to a cashflow advantage for the group as a whole, but that is not the point here. The ECJ only takes account of the fact that the subsidiary benefits from that regime individually. This is quite similar to the approach under Art. 24(5): the fact that a domestic measure benefits a group as a whole is irrelevant, insofar as there are also benefits to the subsidiary individually[2175].

That being said, there is another reason why the ECJ reached a different conclusion in *Metallgesellschaft* than the House of Lords in *Boake Allen*. In the ECJ's analysis, the tax position of the parent company was disregarded in the comparability-test. According to the ECJ, the fact that a non-resident parent company is not liable to ACT is simply because it is not liable to corporation tax in the U.K. (i.e. because it is not a resident). In other words, the ECJ considers the liability to ACT to be inextricably linked with the comparative attribute (the parent company's non-residence). For that reason, that characteristic was left out of the comparability-analysis.

In contrast, the House of Lords in *Boake Allen* held that a resident subsidiary with a non-resident parent is never similar to a resident subsidiary with a resident parent since the latter parent is liable to ACT while the former is not. The term 'similar' refers to all elements that are relevant in the light of the measure at issue apart from the non-residence of the parent company. According to the House of Lords, the parent company's (non-)liability to ACT is a relevant element in this respect. As a result, there is no object of comparison which is entitled to the group election regime, with the result that there is no discrimination. However, as argued in Part II, 2.F.II.D.d, the parent company's liability to ACT is only relevant where the first function of the ACT regime (the credit granted for the purpose of avoiding double taxation on dividends) is concerned. But where the second function is concerned (the prepayment of MCT), the parent company's liability to ACT is irrelevant. Thus, in respect of that function, the situations are comparable. And it is precisely that aspect of the ACT regime that gives rise to the cash-flow disadvantage described above.

In other words, a correct analysis under Art. 24(5) reveals that the issue would have to be decided identically under the tax treaty and under the fundamental freedoms.

V. Disadvantage-test

Finally, the disadvantage-test under Art. 24 is very similar to that applied by the ECJ. However, the scope of the disadvantage-test is narrower under Art. 24 than under the fundamental freedoms. As noted in Part III, 2.E.I.B.b, the ECJ has consistently held that any disadvantage suffered by the subject of comparison, however small, is sufficient to give rise to discrimination. In contrast, each paragraph of Art. 24 specifies the disadvantage that must be present in order for there to be discrimination. This is particularly clear in Art. 24(4), which is only concerned with the conditions for deductibility. Discrimination as regards other aspects of outbound payments do not come within the scope of that provision. Additionally, Art. 24 OECD MC does not preclude the formalities applied to the subject of comparison to be different for practical reasons, as long as this does not result in less favourable treatment. Apart from those limitations, however, there is no *de minimis*-test under Article 24: any disadvantage falling within the scope of application of the relevant paragraph may give rise to discrimination.

[2175] See Part II, 2.F.I.B.b. See also J. AVERY JONES, "The non-discrimination article is about discrimination – official", *B.T.R.* 2007, 4, 350.

Apart from the difference in scope, the mechanism underlying the tests is very similar. In particular, neither standard allows offsetting advantages to counterbalance the challenged disadvantage. As a result, the disadvantage should be considered in isolation, without interference from external factors. As discussed in Part III, 2.E.I.B.f, however, the ECJ has mitigated that strict position somewhat, by accepting that beneficial measures of a bilateral nature may offset the disadvantage if they effectively remove the disadvantage in the full amount and in every situation. Additionally, as noted in Part III, 2.E.I.B.g, the Court does not seem entirely opposed to procedural remedies to remove the challenged disadvantage, provided that certain strict conditions are met.

VI. Conclusion

This overview shows that the main difference between Art. 24 OECD MC and the fundamental freedoms is the scope of application. While Art. 24 remains confined to instances of direct discrimination in the specific areas mentioned in that provision, the fundamental freedoms have been applied in a very liberal manner, covering direct as well as indirect discrimination. And this 'indirect effect' given to the fundamental freedoms is not limited to discrimination against non-residents, but also covers discrimination against taxpayers exercising their fundamental freedoms.

Apart from that difference in scope, however, the standards are remarkably similar. The approach to testing a domestic measure under both standards comes down to first constructing a comparison by determining which characteristics are relevant from the perspective of the domestic measure under scrutiny. If those relevant characteristics are shared by the subject and object of comparison, the situations are comparable (unless the characteristics are inherent in the comparative attribute). If that comparison reveals that the subject of comparison is treated less favourably than the object of comparison, there is discrimination. In general, neither Art. 24 OECD MC, nor the fundamental freedoms allow the challenged disadvantage to be offset by counterbalancing advantages. Additionally, it should be stressed that the fundamental freedoms have **not** been extended to cover **restrictions** in substantive tax matters (see Part III, 2.D.V). From that perspective, only the ECJ's case law on procedural tax matters differs from the standard laid down in Art. 24 OECD MC.

Ultimately, that was the purpose of the present study. By structuring both the standard laid down in Art. 24 OECD MC and the ECJ's case law in an analytical framework, it became clear that many apparent inconsistencies or contradictions can be removed by strictly applying that framework. Moreover, a comparison of both standards reveals that the framework is identical for both standards. So despite the significant difference in scope, the actual mechanism underlying both non-discrimination rules is the same. And that should not really come as a surprise, since the purpose of both rules is very similar. Indeed, both rules are intended to stimulate trade by ensuring a certain standard of treatment for cross-border situations[2176]. It is true that tax treaties generally aim to remove or alleviate international

[2176] The present study is only concerned with the economic aspect of the fundamental freedoms, which is based on the idea that obstacles to cross-border trade should be removed in order to realise an internal market. European law also aims to remove discrimination in a number of other fields, e.g. discrimination between male and female workers. For an overview of the different expressions of the principle of equality in European law, see K. LENAERTS, "L'égalité de traitement en droit Communautaire", *Cahiers de droit européen* 1991, 3-41.

double taxation[2177], but Art. 24 OECD MC has a different objective. That provision does not aim to remove double taxation, but to prevent discrimination against certain categories of taxpayers. Yet, it is clear that non-discriminatory treatment is not aspired to as an objective in itself. Instead, there is an underlying assumption that discriminatory treatment creates market distortions and that free trade is stimulated if the conditions of competition on the domestic market are not less favourable for foreigners, non-residents, etc. And that aim should be seen in the context of the tax treaty's broader purpose. That is to say, the avoidance of double taxation is not an objective in itself. Instead, there is an assumption that double taxation constitutes an obstacle to trade between the contracting States and that it is therefore necessary to remove that obstacle.

To a significant extent, that is also the objective of the fundamental freedoms: the underlying idea is that those freedoms prevent barriers to trade between Member States, with the ultimate aim of realizing an internal market. In order to ensure that objective, the fundamental freedoms have a discrimination- and a restriction-component, that is to say, both discriminatory and (neutral) restrictive measures are considered to constitute an obstacle to the realization of an internal market. As noted earlier, however, the importance of the restriction-component is limited in direct tax matters.

So the ultimate difference between both standards is that the tax treaty non-discrimination provision operates in the framework of a bilateral instrument, while the fundamental freedoms function on a multilateral basis and are therefore suited for a uniform interpretation by the ECJ. And in exercising its judicial role, the ECJ has been quite activistic, trying to fill the legislative gap caused by the lack of positive integration. To a certain degree, that difference should be put into perspective as well, given the OECD's aspiration of ensuring that tax treaties worldwide follow the template of the OECD MC, resulting in a network of identical treaties which are all interpreted in accordance with the OECD Commentary.

> Given the wider scope of protection offered by the fundamental freedoms, one could wonder whether it is still useful for EU Member States to include non-discrimination provisions in their tax treaties. Since the non-discrimination standard of the fundamental freedoms outperforms the standard of Article 24, it could indeed be argued that the tax treaty non-discrimination standard is no longer needed in the Internal Market. There are, however, some important objections against deleting Article 24 from tax treaties. First of all, legal certainty requires there to be a degree of uniformity between tax treaties. It would be difficult for taxpayers (and also for contracting States, and for the OECD) if tax treaties contained fundamentally different provisions depending on the degree of legal integration that exists in a certain regional market. Moreover, it has been stressed earlier that tax treaty provisions are not easily separable, in that they all contribute to an intricate balance between the interests of the two contracting States. It is not clear how the balance of tax treaties would be affected if the non-discrimination provision was left out, simply because its function is fulfilled in a more efficient way by another legal instrument. Secondly, it is not unthinkable that situations would arise where the fundamental freedoms do not apply, but where a taxpayer could nevertheless claim protection under the tax treaty non-discrimination rule[2178]. In such a case, it is essential that the taxpayer

[2177] Introduction to Comm. OECD, para. 3.

[2178] Consider, for instance, the situation where a U.S. national resides in Belgium and carries out an enterprise in Belgium as a self-employed person. He makes a payment to a French service provider but he is unable to deduct that payment because of a restriction under Belgian domestic law, even though it would have been deductible had the payment been made to a Belgian service provider. Assume that the Belgian legislation clearly concerns services, with the result that the free movement of capital cannot be applied (see C-452/04, *Fidium Finanz*, § 34: *"Where a national measure relates to the freedom to provide services and the free movement of capital at the* can fall back on the protection offered by the tax treaty. Finally, the question would arise whether the non-discrimination provision should then also be deleted in tax treaties between a Member State and third countries. A number of situations involving third countries are covered by the free movement of capital, but the free movement of capital does not apply where the issue primarily concerns another freedom (i.e. the freedom of establishment or the freedom to provide services). Consequently, it would be necessary to draft Article 24 in such a way that it would only apply where the free movement of capital is inapplicable because another freedom applies. And that would be quite difficult, given the factual nature of the test developed by the ECJ in that regard[2179]. Moreover, an exception would have to be made for national measures that cannot be tested against the free movement of capital because they are grandfathered under Article 64 TFEU.

B. Justification grounds

It is often thought that one of the main differences between Art. 24 OECD MC and the non-discrimination standard developed by the ECJ is that the former does not allow for discrimination to be justified while the latter does. Closer analysis, however, reveals that this issue is not that straightforward. Indeed, a number of justification grounds can be applied under Article 24 because they are provided for in the Commentary.

First of all, the Commentary states that additional information requirements are not contrary to Arts. 24(4) or Art. 24(5) because such requirements are intended to ensure similar levels of compliance and verification for subject and object of comparison[2180]. As an example, consider the *Talotta* case, discussed in Part III, 2.E.I.A.b.8.a. That case concerned Belgian rules pursuant to which a non-resident's Belgian PE could be taxed on the basis of a minimum tax base, determined by reference to the turnover and the size of the workforce, if the tax authorities did not have the necessary evidence to determine the actual tax base. In contrast, where resident taxpayers were concerned the Belgian tax authorities could also apply other methods to determine the taxable profits.

In challenging this distinction, Mr Talotta did not only invoke the fundamental freedoms, but also the PE non-discrimination clause of the Belgian/Luxembourg treaty[2181]. The Court of Appeal dismissed that claim and held that case law had already indicated that the tax treaty non-discrimination provision does not prohibit that the PE of a non-resident is taxed differently from a Belgian resident for practical reasons[2182]. That conclusion was upheld by

---

same time, it is necessary to consider to what extent the exercise of those fundamental liberties is affected and whether [...] one of those prevails over the other [...]. The Court will in principle examine the measure in dispute in relation to only one of those two freedoms if it appears, in the circumstances of the case, that one of them is entirely secondary in relation to the other and may be considered together with it"). The taxpayer cannot invoke the (passive aspect of the) freedom to provide services since he is not a EU citizen. He can, however, rely on Art. 24(4) of the treaty between Belgium and France, since the payment would have been deductible if it had been made to a Belgian recipient.

[2179] This is particularly true for the relationship capital – establishment. Compare, for instance, C-251/98, *Baars*, § 21-22; C-157/05, *Holböck*, § 23-30; C-446/04, *FII*, § 37 and 58; C-196/04, *Cadbury Schweppes*, § 32 and C-492/04, *Lasertec*, § 21-22.

[2180] Comm. OECD on Art. 24, paras. 75 and 80. See also Comm. OECD on Art. 9, para. 4.

[2181] Art. 24(5) of the 1970 treaty, which is identical to Art. 24(4) of the 1963 OECD Draft Convention.

[2182] Liège Court of Appeal 16 June 2004, *FJF* 2005/18: *"la jurisprudence a déjà souligné que le principe d'égalité consacré par une convention de double imposition ne s'opposait à ce que pour des raisons pratiques, l'établissement d'une entreprise étrangère soit imposé différemment d'une entreprise belge"* (referring to Brussels Court of Appeal 30 June 1994, which was discussed in Part II, 2.D.III.C.a.1).

the Supreme Court[2183]. As to the claim under the fundamental freedoms, the Supreme Court referred the matter to the ECJ, which ultimately held that the distinction resulting from the Belgian rules infringed the freedom of establishment.

Interestingly, the ECJ also addressed the practical difficulties that made it more difficult for the Belgian tax authorities to determine a non-resident's PE taxable base. The ECJ did not accept that those practical difficulties could justify the discrimination because the taxation of residents and the taxation of non-residents presented the Belgian tax authorities with the same practical difficulties and because those tax authorities were free to rely on the Mutual Assistance Directive[2184].

As noted in Part III, 2.E.I.A.b.8, the ECJ has consistently dismissed arguments concerning the lack of information necessary to apply domestic tax rules in situations where the Mutual Assistance Directive applies. In contrast, such a lack of information may be relied upon where the Directive does not apply (nor a similar legal instrument). However, if a legal instrument applies that ensures the tax authorities of the Member State concerned that information provided by the taxpayer is reliable and verifiable, the taxpayer should be given the opportunity to provide the necessary information. That approach is more nuanced than the blunt statement in the Commentary that additional information requirements do not constitute discrimination. But apart from that difference, it seems that the lack of information may constitute a justification ground both under Art. 24 and under the fundamental freedoms.

In this respect, reference should be made to the discussion concerning the distinction between justification grounds and arguments relating to the comparability of the situations (see Part II, 2.F.IV). As argued there, arguments based on elements that are inherent in the comparative attribute cannot be taken into consideration in the comparability-analysis. Clearly, the greater administrative difficulties faced by the Belgian tax authorities when assessing a non-resident taxpayer to tax are precisely due to that taxpayer's non-residence. Since that characteristic is inherent in the comparative attribute, it should be left out of the comparability-analysis. Instead, it can only be considered under the justification-analysis[2185].

This conclusion does not apply to the statement in Comm. OECD on Art. 24, para. 13. There, it is stated that Art. 24(1) does not require a State which accords special taxation privileges to private institutions not for profit whose activities are performed for purposes of public benefit, which are specific to that State, to extend the same privileges to similar institutions whose activities are not for its benefit. According to the Commentary, *"if a State accords taxation privileges to certain private institutions not for profit, this is clearly **justified** by the very nature of these institutions' activities and by the benefit which that State and its nationals will derive from those activities"*[2186].

[2183] Belgian Supreme Court 7 October 2005, No. AR F.04.0045.F, *Pas.* 2005, afl. 9-10, 1859.
[2184] C-383/05, *Talotta*, § 36.
[2185] A similar point can be made with respect to the issue discussed in Part II, 2.B.V.A. If nationality is used as the criterion for determining the scope of tax liability, then the different scope in tax liability between nationals and non-nationals cannot be said to render the situations incomparable for purposes of Art. 24(1). Characteristics that are inextricably linked with the comparative attribute should be left out of the comparability-analysis. So the observation in the Commentary that the U.S. considers that non-resident nationals *"are not in the same circumstances"* as other non-residents could be seen as a justification ground, rather than an aspect of comparability.
[2186] Comm. OECD on Art. 24, paras. 11 and 13 (emphasis added).

This seems to be a justification ground but, in reality, it is an aspect of the comparability-test. In particular, because domestic non-profit organisations perform activities that are to the benefit of the State in question, they are not comparable to foreign non-profit organisations (who do not perform activities to the benefits of that State)[2187]. But the performance of those specific activities is not inherently linked with the nationality of the organisations.

Another possible justification ground under Art. 24 OECD MC relates specifically to Art. 24(4). That provision expressly provides that it can only be applied if Arts. 9(1), 11(6) and 12(4) do not apply. Consequently, where a domestic thin cap measure complies with the arm's length requirements as provided for in those articles, there is no discrimination. As noted above, that is very similar to the justification ground developed by the ECJ in relation to thin cap cases.

A final possibility to justify discrimination under Art. 24 OECD MC is to incorporate elements of the justification-analysis in either the comparability- or the disadvantage-test. This possibility was referred to earlier, in Part II, 2.B.VIII and Part II, 2.B.IX. But this is rarely done in practice. Cases where it does happen are very scarce (e.g. the *Hoechst* case, discussed in Part II, 2.B.IX).

In conclusion, the traditional view that Art. 24 OECD MC does not offer any room for justification grounds is not entirely correct, but it is not far from the truth either. Because there is no 'open standard' allowing for any public policy reason in the general interest to be invoked and because such justification grounds cannot be incorporated in the comparability- and disadvantage-test, the only safety valves in Art. 24 are those that are expressly provided for either in the text of the provision or in the Commentary (the most notable example being the reference in Art. 24(4) to the arm's length standard).

So the question arises whether Art. 24 should be amended so as to allow for other justification grounds than those discussed above, e.g. by providing that discrimination is justified when it is a necessary and proportionate means to achieve a public policy objective. In my opinion, that is not the case. As noted in Part III, 2.F.III, justification grounds are essentially related to characteristics that are inextricably linked with the comparative attribute but should nevertheless be considered because they reflect an objective that outwheighs the need to ensure non-discriminatory treatment. Generally, the justification-analysis comes down to balancing a State's interest in exercising its sovereignty by applying direct tax measures against a taxpayer's interest in not being discriminated against. Finding this balance is, to a significant extent, a subjective affair, in that it reflects an underlying policy of tax integration. The more priority is given to a State's objections on public policy grounds, the slower the removal of tax obstacles impeding cross-border activity. So deciding whether or not to accept a justification ground implies that one has a certain idea as to the degree of tax integration that is desirable. But since this is a matter of policy, it requires uniform application. If different courts have different conceptions of the appropriate balance between these interests, the result would be a fragmented application of the non-discrimination provision. The difference with the 'European' standard is that the ECJ ensures a certain degree of uniformity in this analysis. But since there is no single judicial body ensuring that the case law under Art. 24 is guided by a uniform policy on the appropriate degree of tax integration, the use of an open standard is impossible. In my opinion, therefore, allowing national courts to develop a rule of reason mechanism under Article 24, similar to the mechanism developed by the ECJ under the

[2187] In this respect, see also infra, 2.B.I.A.1.

fundamental freedoms, would not be desirable since it could lead to a considerable degree of uncertainty.

That being said, there are indications that the influence of the ECJ's case law may have some repercussions on this status quo. As will be pointed out hereafter, it seems that national courts in EU Member States are being influenced by that case law when interpreting Art. 24 OECD MC. Consequently, there is a possibility that those national courts feel that the justification grounds developed by the ECJ should also be transposed to Art. 24 OECD MC (see, in particular, Verwaltungsgerichtshof 16 February 2006, which will be discussed in 2.B.I.A.d). Whether such an influence has any legal basis will be discussed in 2.II.

2. The interaction between the ECJ's standard and tax treaties

A. General

Even though the non-discrimination standards embodied by Art. 24 OECD MC and the ECJ's case law are quite similar, both in purpose and in content (see infra), it seems that there is remarkably little interaction between them. In this respect, 'interaction' can be interpreted in two ways. A first type of interaction refers to the idea that a taxpayer can rely on one non-discrimination rule in order to claim entitlement to benefits granted under another non-discrimination rule. The second type of interaction is that the interpretation of one non-discrimination rule is influenced by the interpretation of another non-discrimination rule.

Since the first type of interaction has already been discussed earlier (see Part II, 2.F.II.D.c and Part III, I.A.b.9), only the second type will be discussed here. Nevertheless, it is useful to briefly describe the first type of interaction, in order to distinguish it from the second type. The first type of interaction starts from the idea that a non-discrimination rule entitles the subject of comparison to a certain standard of treatment. Consequently, one may wonder whether two non-discrimination rules can be combined, in that a non-discrimination rule opens the door towards all benefits guaranteed under another non-discrimination rule. For the purpose of the present study, that question goes both ways.

On the one hand, the question arises whether a non-discrimination provision in a tax treaty between an EU Member State and a third State opens the door for residents of that third State to all the benefits granted European (primary or secondary) tax law. That issue was already discussed in Part II, 2.F.II.D.c. As pointed out there, benefits granted under a regional legal instrument that is intended to achieve market integration cannot be considered to be part of the 'national treatment' to which a taxpayer is entitled under a tax treaty non-discrimination clause. In the EU context, such benefits are inextricably bound up with the European purpose of market integration and entitlement to them is an inherent feature of European citizenship.

On the other hand, the question arises whether the fundamental freedoms require a Member State to extend the benefits it has granted under a tax treaty to residents of other Member States. That issue was discussed at length in Part III, I.A.b.9, where it was concluded that, while MFN treatment is desirable from an internal market perspective, the current state of EU law does not seem to allow for an interpretation of the freedoms allowing for such treatment. As discussed above, the ECJ has not interpreted the non-discrimination standard underlying the fundamental freedoms to require that benefits granted under a tax treaty are extended to residents of EU Member States. The reciprocity inherent in a tax treaty precludes that those benefits would be extended to residents of States that are not party to the treaty.

This section is only concerned with the second meaning of 'interaction', namely the question whether the interpretation of one non-discrimination rule is influenced by the interpretation of the other non-discrimination rule. The most obvious question would then be whether the interpretation of Art. 24 OECD MC has taken a cue from the enormous evolution of the 'European' standard of non-discrimination that has occurred in the past three decades. More specifically, it is possible that national courts interpreting Article 24 OECD MC start incorporating elements developed by the ECJ (e.g. the concept of indirect discrimination, justification grounds, etc.).

B. The interpretation of Art. 24 OECD MC in EU Member States

Given the increasing importance of the fundamental freedoms in matters of direct taxation, the question arises whether national courts of EU Member States should take account of the ECJ's case law when deciding cases under the non-discrimination provision of a tax treaty, especially when it concerns a tax treaty between EU Member States.

This question will be addressed in two steps. First, it will be determined whether the decisions of national courts under Art. 24 that were discussed in Parts II and IV may have been influenced by the ECJ's case law. More specifically, it is necessary to determine whether national courts in EU Member States have reached different results in applying Art. 24 OECD MC than other national courts because of the influence of the ECJ's case law. Secondly, there will be a discussion as to whether such an influence is necessary, i.e. whether Member States are required to take account of the ECJ's case law when interpreting and applying the non-discrimination provision in their tax treaties with other EU Member States.

I. Case law

I.A. General

There is a perception in legal literature that national courts in EU Member States give a broader interpretation to Art. 24 OECD MC than national courts in non-EU Member States. Furthermore, it is assumed that this broader interpretation can be explained because national courts in EU Member States are influenced by the ECJ's case law when interpreting Art. 24[2188].

If there is indeed such an influence of the ECJ's case law on the interpretation of Art. 24, one would expect it to be translated into a higher rate of success for taxpayers invoking Art. 24 before national courts of EU Member States. There are two reasons for this assumption. First

[2188] L. HINNEKENS and P. HINNEKENS, "General report", in IFA, *Cahiers de droit fiscal international. Non-discrimination at the crossroads of international taxation*, Vol. 93a, Amersfoort, Sdu Fiscale & Financiële Uitgevers, 2008, 39. See also M. BENNETT, "Nondiscrimination in international tax law: a concept in search of a principle", 59 *Tax Law Review* 440, 2005-2006: *"It has become impossble to ignore the impact of [the ECJ's] jurisprudence on the analysis of bilateral tax treaty nondiscrimination issues, even though many in the tax treaty world would like to politely pretend that the ECJ has no direct relevance to tax treaty provisions and therefore cannot cause any discomfort."*

of all, in the majority of cases where the ECJ applies the fundamental freedoms to national tax measures of Member States, the decision is in favour of the taxpayer: in 122 decisions rendered since 1986, the ECJ decided in favour of the taxpayer 93 times (i.e. 76.230%)[2189]. Secondly, in all of the cases where the influence of the ECJ's case law on the interpretation of Art. 24 OECD MC was expressly recognized by the national court (see infra), the non-discrimination issue was decided in favour of the taxpayer.

The following table can be a first indication as to whether there is such an influence. This table includes 160 cases decided by national courts under Art. 24, most of which were referred to in Part II[2190]. A distinction is made between decisions of national courts of EU Member States and decisions of national courts of non-EU Member States. The second and third column indicate the number of cases that were decided in favour of the taxpayer and the number of cases that were decided in favour of the tax authorities.

National Court of	Decision in favour of	
	Taxpayer	Tax authorities
EU Member State	48	65
Non-Member State	13	34

In percentages, national courts in EU Member States decided 42% of the cases in favour of the taxpayer and 58% of the cases in favour of the tax authorities[2191]. In contrast, national courts in non-EU Member States only decided 28% of the cases in favour of the taxpayer and 72% of cases in favour of the tax authorities[2192]. This is a significant difference, which might indicate a more lenient approach to Art. 24 OECD MC by nationals courts in EU Member States (supposedly as a result of the influence of the ECJ's case law).

Assuming that national courts in EU Member States are indeed influenced by the ECJ's case law when interpreting Art. 24, one would expect this influence to be more pronounced in cases concerning a tax treaty between two Member States. As noted before, the free movement of capital in relation to third States is based on the same conception of non-discrimination as the fundamental freedoms in relation between Member States, but the ECJ has accepted that its scope is more limited because of the inapplicability of certain EU instruments in relation to third States. Consequently, one would expect there to be less of an influence of the ECJ's case law where national courts of Member States decide issues involving a treaty with a non-Member State.

In order to verify whether that is indeed the case, the cases included in the table above are split up according to whether the case concerned a tax treaty with a Member State or with a non-Member State. The result is set out in the following table:

[2189] For an overview of the cases included in this analysis, see Annex 1.
[2190] For an overview of the cases included in the table, see Annex 2. Cases where the taxpayer's claim is dismissed on the basis that the non-discrimination provision was not implemented in domestic law (e.g. *UBS*) are considered to have been decided in favour of the tax authorities. It should be stressed that this list is by no means exhaustive. So when interpreting this data, it should always be kept in mind that it depends on which cases happen to have been published. Nevertheless, the analysis reveals some interesting insights.
[2191] 42.478% versus 57.522%.
[2192] 27.660% versus 72.340%.

National Court of	Treaty with	Decision in favour of	
		Taxpayer	Tax authorities
EU Member State	EU Member State	20	44
	Non-EU Member State	28	21
Non-EU Member State	EU Member State	7	19
	Non-EU Member State	6	15

As could be expected, this division does not make a difference for national courts of non-Member States. In cases concerning a treaty with an EU Member State, 27% of the decisions were in favour of the taxpayer while 73% were in favour of the tax authorities[2193]. Approximately the same result can be seen for cases concerning a treaty with a non-Member State: 29% versus 71%[2194]. These values are quite close to the 28% versus 72% relation in the overall result of the cases decided by national courts of non-EU Member States (see supra), so it does not make a difference whether a national court of a non-Member State decides a case involving a treaty with a Member State or a treaty with a non-Member State.

But a division according to the status of the treaty partner does make a difference for decisions given by national courts of EU Member States. Where those courts decided a case involving a treaty with another EU Member State, 31% of the decisions were in favour of the taxpayer while 69% of the decisions were in favour of the tax authorities[2195]. This is very close to the 28% versus 72% relation in the decisions by national courts in non-Member States (see supra), which would suggest that national courts of EU Member States are **not** influenced by the ECJ's case law when deciding a case involving a tax treaty with another Member State.

In contrast, where national courts of Member States decided a case involving a treaty with a non-Member State, 57% of the decisions were in favour of the taxpayer while 43% of the decisions were in favour of the tax authorities[2196].

This remarkable divergence seems to suggest that the interpretation of Art. 24 by national courts of EU Member States is more liberal where a treaty with a non-Member State is concerned. This is counterintuitive because, as pointed out above, the limited scope of the free movement of capital would lead one to expect that the influence of the ECJ's case law (which can, hypothetically, be translated into a higher success rate for the taxpayer) to be less pronounced in situations involving third States.

Of course, the data contained in the tables above may be misleading because it does not reflect the evolution of case law over time. As a result of the explosive growth of the ECJ's case law on direct tax matters since 1990, Member States have become increasingly aware of

[2193] 26.923% versus 73.077%.
[2194] 28.571% versus 71.429%.
[2195] 31.25% versus 68.75%.
[2196] 57.143% versus 42.857%.

the importance of European law in matters of direct taxation. So it is possible that the influence of the ECJ's case law has become more pronounced in the past decades. In other words, if it is true that national courts are influenced by the ECJ's case law when interpreting Art. 24, it can be expected that that influence has increased in the past decades, meaning that, gradually, the percentage of decisions in favour of the taxpayer under Art. 24 OECD MC has increased. The following chart sets out the number of decisions by national courts of EU Member States in favour of the taxpayer and those in favour of the tax authorities on a timeline[2197].

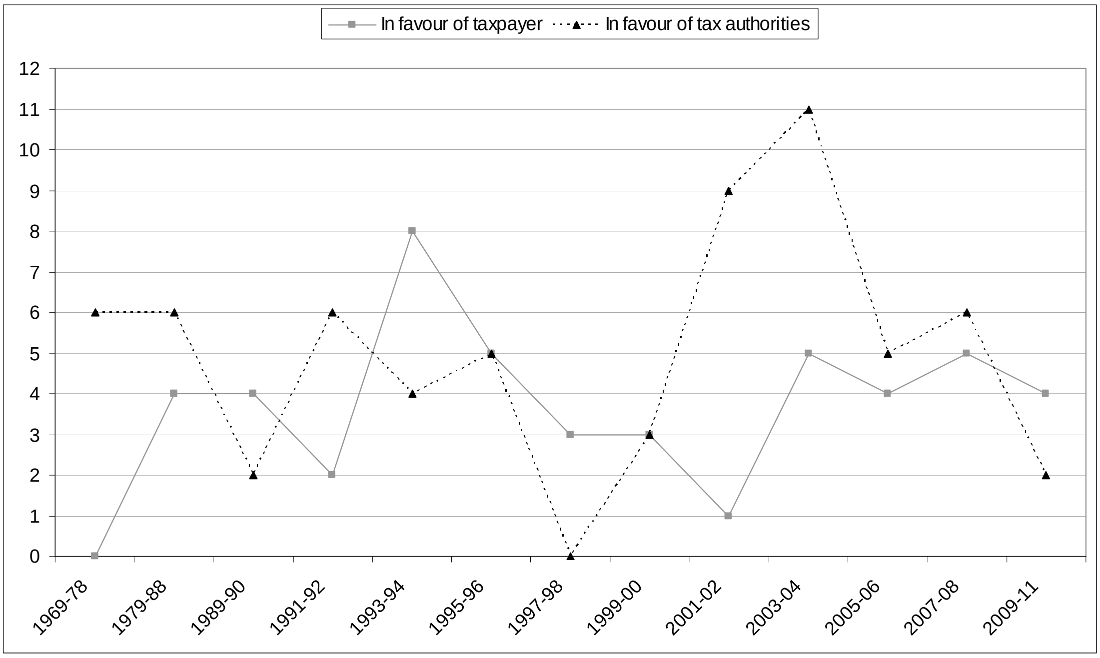


Chart 1: evolution of decisions of national courts of EU Member States

This chart does not show a clear evolution. Apart from a sudden surge in decisions in favour of the tax authorities in the period 1999-2004, the number of decisions in favour of the taxpayer stays more or less the same as the number of decisions in favour of the tax authorities. So from this overall perspective, it does not seem that the attitude of national courts of Member States towards Art. 24 has changed over time.

Given the significant difference between decisions concerning a tax treaty with another Member State and decisions concerning a tax treaty with a non-Member State (see supra), it may be useful to make that distinction for the purpose of the chronological evolution as well. First, the following chart includes the decisions of courts in EU Member States where a treaty with another Member State was concerned.

[2197] The x-axis shows the year in which the decisions were given, while the y-axis shows the number of decisions. The x-axis is divided periods of two years, apart from the period before 1988: because of the limited number of cases in that period, ten-year periods are used there.

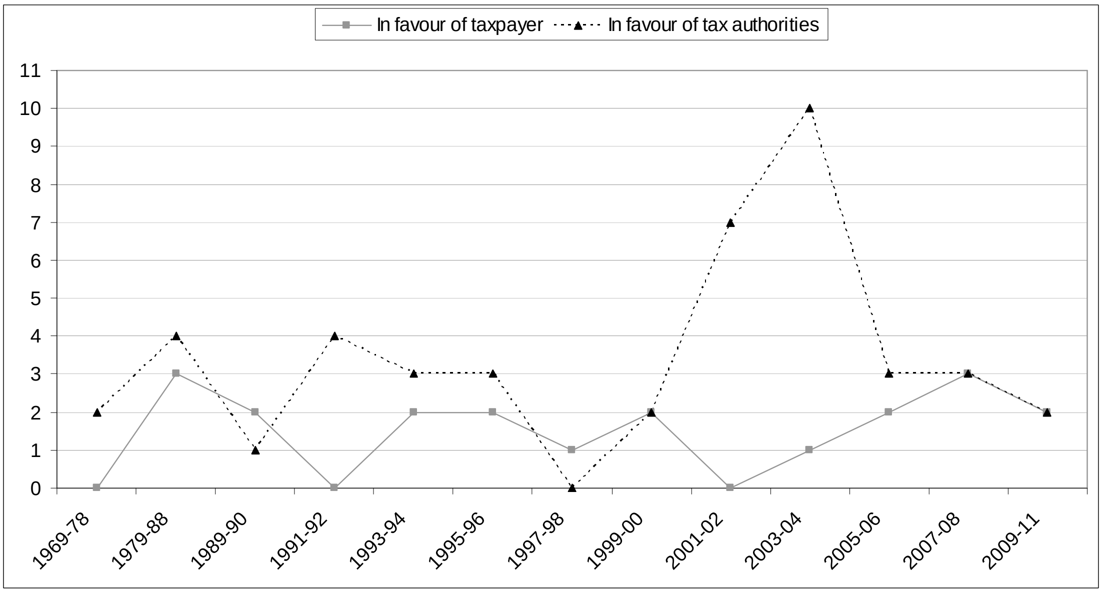


Chart 2: evolution of decisions of national courts of EU Member States concerning treaties with Member States

Once again, the chart does not show a clear evolution. The number of decisions in favour of the taxpayer stays more or less the same, without any peaks. The number of decisions in favour of the tax authorities is also quite constant, apart from a peak in the period 1999-2004. Contrary to what could be expected (see supra), the number of decisions in favour of the taxpayer does not increase gradually as a result of the growth of the ECJ's body of case law. On the contrary, the number of decisions in favour of the tax authorities is consistently equal to or exceeds the number of decisions in favour of the taxpayer since 1989 (apart from the period 1989-90 and 1997-98).

Finally, the following chart includes the decisions of courts in EU Member States concerning a treaty with a non-Member State.

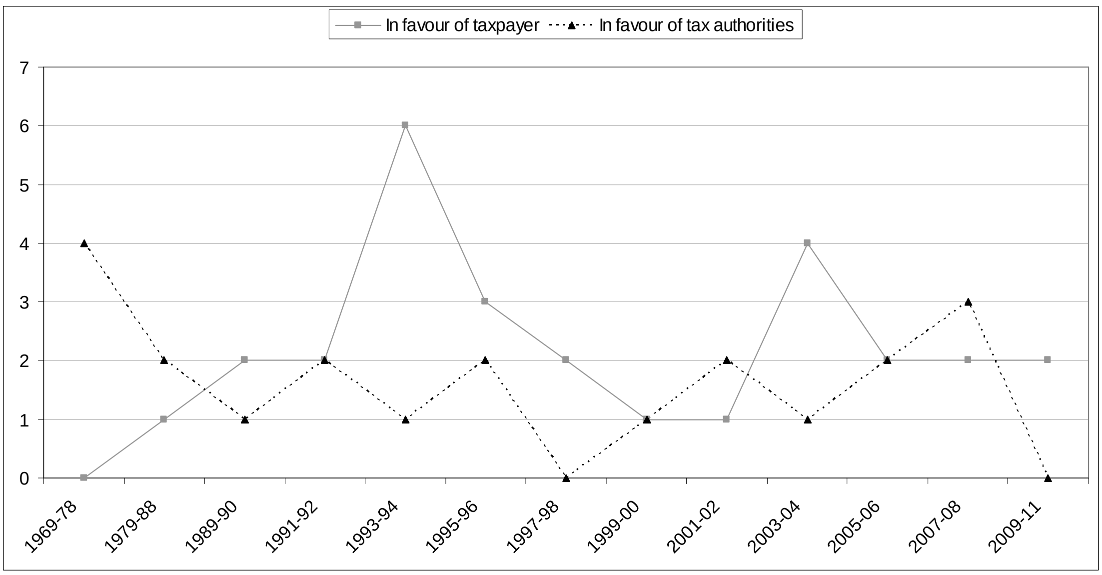


Chart 3: evolution of decisions of national courts of EU Member States concerning treaties with non-Member States

This chart shows that there is no clear evolution over time in this category of cases. The only clear trend that emerges from the chart is that the number of decisions in favour of the taxpayer consistently exceeds the number of decisions in favour of the tax authorities since 1989 (apart from the slight drop in the period 1999-2002 and 2007-08). Once again, this is a remarkable finding.

A possible explanation of these charts could be that, because of the growing awareness of the importance of EU law in matters of direct taxation, Member States have started to amend their domestic legislation so as to remove incompatibilities with European law. And because the requirements imposed by the non-discrimination standard of Art. 24 OECD MC are so similar to those imposed by the fundamental freedoms, the removal of those incompatibilities with European law automatically means that the domestic legislation is no longer incompatible with Art. 24 either. In relation to other Member States, therefore, discriminatory legislation has been removed to a significant extent. That explains why, in cases involving a treaty with another Member State, the number of decisions in favour of the tax authorities has consistently exceeded the number of decisions in favour of the taxpayer since 1989 (see chart 2): since the domestic law is compatible with the fundamental freedoms, a challenge on the basis of Art. 24 will also fail.

On the other hand, Member States may tend to restrict themselves to doing what is strictly necessary in order to ensure compatibility with European law. For that reason, domestic legislation will often be made non-discriminatory only in relation to other Member States. Discrimination therefore still persists in relation to third States. That may explain why challenges on the basis of Art. 24 have been consistently succesful in the past few decades (see chart 3).

An additional explanation – which is related to the foregoing – might be that taxpayers are more inclined to rely on the fundamental freedoms where possible because of the stronger protection offered as compared to Art. 24 OECD MC. So in situations where the fundamental freedoms can be applied, i.e. in cases where another Member State is involved, discriminatory treatment will generally be challenged on the basis of the fundamental freedoms. Only where the fundamental freedoms cannot be applied, i.e. in cases where a third State is involved (barring the possible application of the free movement of capital), will taxpayers rely on the tax treaty non-discrimination provision. So the same discriminatory treatment will be struck down in both contexts, on the basis of the fundamental freedoms where possible and, in other cases, on the basis of Art. 24. In other words, the apparent higher success rate for taxpayers relying on Art. 24 in a situation involving a third State may be explained by their reluctance to rely on that provision where other options (i.e. the fundamental freedoms) are available.

In conclusion, if one assumes that an influence of the ECJ's case law on the interpretation of Art. 24 OECD MC would result in a more liberal approach towards that provision by national courts of EU Member States (meaning that decisions given by national courts of EU Member States are more often in favour of the taxpayer than decisions given by national courts of third States), then the above analysis suggests that there is no such influence. The interpretation given to Art. 24 by national courts of EU Member States and national courts of third States seems to be identical, unless where national courts of EU Member States decide cases involving a third State. In the latter situation, taxpayers relying on Art. 24 are more successful but it is unlikely that this can be explained by an influence of the ECJ's case law. Instead, it seems that the different results in that context can be explained by the fact that the ongoing integration of the European internal market has exposed (or even created) discriminations in relation to third States.

Of course, these charts and tables can only be a preliminary indication of a possible influence. Indeed, the outcome of all of the decisions included in the analysis was to a significant extent determined by the specific facts at issue. Additionally, because the number of reported cases on Art. 24 (and, therefore, the number of cases included in this analysis) is still relatively low, it may not be appropriate to attach much importance to these results and, in particular, to the evolution of case law over time as set out in the charts above. For that reason, it is necessary to find cases where the national court expressly recognized that there was some form of influence. On the basis of such cases, more accurate conclusions may be drawn.

a. The comparability of non-profit organisations

In a case decided in 2007, the Paris Administrative Court of Appeal was asked to decide on the tax treatment in France of pension funds that sold shares in a French real estate company[2198]. Interestingly, the case was addressed both from the perspective of the tax treaty non-discrimination clause and that of the free movement of capital.

The taxpayer was a Dutch pension fund that sold shares in French real estate companies. Pursuant to the applicable French tax legislation, that disposal gave rise to a capital gains tax in France at a rate of 33.33%. In contrast, if the taxpayer had been a French pension fund, it would be exempt from the capital gains tax. The taxpayer therefore argued that the French rules fell foul of the nationality non-discrimination clause in the Dutch/French treaty[2199] and the free movement of capital. The French tax authorities relied on the OECD Commentary and argued that the tax treaty non-discrimination clause did not require France to extend benefits granted to non-profit organizations whose activities are performed for purposes of public benefit which are specific to that State to similar institutions of the other contracting State[2200].

The Court first observed that the profits generated from the Dutch pension fund's investments were used exclusively to finance the social benefits guaranteed to its policy-holders and that no profit was distributed. The Court therefore held that the pension fund had to be considered as a non-profit organization with a social purpose.

[2198] Cour Administrative d'Appel de Paris 6 December 2007, No. 06PA03370, *Fondation Stichting Unilever Pensioenfonds Progress*. That Court applied the exact same line of reasoning and reached the same conclusion in two similar case decided on the same day (also concerning the Dutch/French treaty): Cour Administrative d'Appel de Paris 6 December 2007, No. 06PA03371, *Fondation Stichting Providentia* and Cour Administrative d'Appel de Paris 6 December 2007, No. 07PA01717, *Fondation Stichting Pensioenfonds Hoogovens*. See also Conseil d'Etat 5 July 2010, No. 309693, *Pinacothèque d'Athènes*, where a similar issue was decided in favour of the taxpayer under the nationality non-discrimination clause of the French/Greek treaty without, however, developing any substantial argumentation.
[2199] Art. 25(1) of the 1973 treaty, which is substantially identical to Art. 24 OECD MC.
[2200] See Comm. OECD on Art. 24, paras. 11 and 13: "*[Art. 24(1) is not] to be construed as obliging a State which accords special taxation privileges to private institutions not for profit whose activities are performed for purposes of public benefit which are specific to that State, to extend the same privileges to similar institutions whose activities are not for its benefit. […] If a State accords taxation privileges to certain private institutions not for profit, this is clearly justified by the very nature of these institutions' activities and by the benefit which that State and its nationals will derive from those activities.*"

The Court then held that the difference in treatment introduced by the French rules was based on the entity's corporate seat, i.e. its nationality[2201]. A French non-profit organization that administered a pension fund and sold shares in a French real estate company would be exempt from the French capital gains tax. As the taxpayer was comparable to such a French pension fund for the purposes of the transaction in question, the Court held that the application of the capital gains tax fell foul of the nationality non-discrimination clause of the Dutch/French treaty[2202].

As pointed out above, the tax authorities had relied on Comm. OECD on Art. 24, paras. 11 and 13 to argue that the non-discrimination provision could not be applied to non-profit organisations. The Court dismisses that argument by pointing that there was nothing to indicate that the contracting parties to the Dutch/French tax treaty intended to give the non-discrimination provision the interpretation provided for in para. 11 of the Commentary on Art. 24. Furthermore, the tax authorities could not rely on Comm. OECD para. 13 because that statement was subsequent to the tax treaty[2203].

The Court then addresses the compatibility with the free movement of capital. In that respect, the Court refers to the ECJ's decision in *Stauffer* and notes that that decision implies that the difference in treatment introduced by the French rules at issue was incompatible with the free movement of capital unless it concerned incomparable situations or unless it was justified. With respect to comparability, the Court holds that, **as it decided earlier in the context of the tax treaty non-discrimination clause**, the taxpayer was comparable to a French pension

---

[2201] This is a remarkable statement. The French measure at issue distinguished on the basis of the corporate seat ('*siège social*'), which refers to residence. Since the case thus concerned discrimination on the basis of residence rather than discrimination on the basis of nationality, it did not come within the scope of application of Art. 24(1) (see also L. DE BROE and R. NEYT, "Tax treatment of cross-border pensions under the OECD Model and EU law", *Bull. IBFD* 2009, 90). There is no indication in the judgment that this is an example of a broad interpretation of Article 24, due to an influence by the ECJ's case law. See also Part II, 2.B.III.B, on the distinction between nationality and residence with respect to legal entities. For further background on the French distinction in that regard, see N. DE BOYNES, "France", in G. MAISTO (ed.), *Residence of companies under tax treaties and EC law*, Amsterdam, IBFD, 2009, 441-459.

[2202] The original text of the decision reads as follows: *"les ressources de la Fondation […] sont exclusivement affectées à des investissements dont les produits financent les diverses prestations sociales qu'elle sert à ses assurés, à l'exclusion de toute distribution de résultats; que, dans ces conditions, cette fondation, gérant un régime de retraite et de prévoyance, doit être regardée comme ayant un objet social à but non lucratif; […] la différence de traitement qu'instaurent ces dispositions est fondée, s'agissant des personnes morales, sur le lieu de leur siège social qui détermine leur nationalité; […] une institution française à but non lucratif gérant un régime de retraite et de prévoyance procédant à la cession de droits sociaux qu'elle détiendrait dans une société française ne serait pas assujettie à l'impôt sur les sociétés sur l'éventuelle plus-value réalisée; que, dès lors, la Fondation Stichting Unilever Pensioenfonds Progress, dont il ne résulte pas de l'instruction qu'elle ait été, en ce qui concerne l'opération génératrice du prélèvement litigieux, dans une situation différente de celle d'institutions françaises réalisant le même type d'opérations, est fondée à soutenir que […] l'administration l'a soumise, en raison de sa nationalité, à une imposition autre ou plus lourde que celle à laquelle aurait été assujettie une institution française gérant un régime de retraite et de prévoyance qui aurait réalisé la même opération imposable".*

[2203] The original text of the decision reads as follows: *"le ministre soutient que la clause de non-discrimination ne s'applique pas aux personnes morales à but non lucratif en se référant au paragraphe [11] des commentaires de l'OCDE sur le modèle de convention fiscale […]; que, toutefois, il ne ressort pas des pièces du dossier que l'intention des parties à la convention fiscale franco-néerlandaise aurait été de donner aux stipulations de l'article 25 de ladite convention la portée résultant de ces commentaires supplémentaires; qu'enfin le ministre ne saurait, en tout état de cause, invoquer les dispositions du paragraphe [13] de ces commentaires, qui sont postérieures auxdites stipulations"*. The statement that para. 13 cannot be relied on because it is subsequent to the 1973 Dutch/French treaty is remarkable since that paragraph was already included in the 1963 Commentary (Comm. OECD 1963 on Art. 24, para. 7).

fund. With respect to the justification, the Court holds that the mere fact that French pension funds ensure activities for the public benefit cannot constitute a valid justification ground[2204].

What is interesting is that the Court expressly conforms the comparability-test under the free movement of capital to that under Art. 24(1) OECD MC. So the Court suggests that, because the situations are comparable under the tax treaty, they are also comparable under the free movement of capital. Unfortunately, the Court does not indicate **why** the comparability analysis should be the same. Likewise, it does not expressly say that its analysis under the tax treaty non-discrimination clause has been influenced by the ECJ's case law. But it is interesting to note that the **reason** why the situations are held to be comparable under the tax treaty, is that the foreign pension fund had to be considered as a non-profit organization with a social purpose, because the profits generated from its investments were used exclusively to finance the social benefits guaranteed to its policy-holders, without any profit being distributed. Such a foreign pension fund was comparable to a French non-profit organization that administered a pension fund.

That line of reasoning is remarkably similar to the analysis developed by the ECJ in its case law on the comparability of charities (see Part III, I.A.b.10). In those cases, the ECJ has held that a charitable organisation established in Member State A is comparable to a charitable organisation established in Member State B if the former organisation meets the requirements for obtaining charitable status in Member State B (e.g. exclusively and directly pursuing charitable objectives) and if the charitable objective pursued by that organisation is recognised in Member State B as an interest of the general public which should be encouraged by tax advantages. Perhaps the implicit influence of the ECJ's case law also explains the Court's remarkable[2205] statement that there was nothing to indicate that the contracting parties to the Dutch/French tax treaty intended to give the non-discrimination provision the interpretation provided for in the OECD Commentary (according to which the non-discrimination clause does not apply to benefits granted to non-profit organisations whose activities are to the public benefit of one contracting State). But it is difficult to draw any conclusions from the decision on this point because, as noted above, it does not specify whether the Court's analysis under Art. 24 was influenced by the ECJ's case law.

[2204] The original text of the decision reads as follows: *"Considérant, au surplus, qu'il résulte de la jurisprudence de la CJCE, et notamment du point 32 de la décision […] Stauffer, que la différence de traitement instituée par les dispositions de l'article 244 bis A du code général des impôts entre les organismes à but non lucratifs résidents ou non résidents doit, sauf à méconnaître les dispositions du traité des communautés européennes relatives à la libre circulation des capitaux, être justifiée par une raison impérieuse d'intérêt général ou concerner des situations qui ne sont pas objectivement comparables; que, d'une part, la Fondation Stichting Unilever Pensioenfonds Progress n'étant pas,* ***ainsi qu'il a été dit ci-dessus****, dans une situation différente des institutions françaises à but non lucratif gérant un régime de retraite et de prévoyance, elle est donc, en tout état de cause, placée dans une situation objectivement comparable à ces dernières; que, d'autre part, si le ministre relève que lesdites institutions assurent des missions de service public, cette circonstance ne saurait établir une raison impérieuse d'intérêt général permettant de déroger au principe de libre circulation des capitaux institué par l'article 56 du traité des communautés européennes"* (emphasis added).

[2205] It is remarkable because it can be assumed that OECD Members who have not made observations or reservations on the Commentary agree with the position taken in the Commentary. See, in general, D. WARD, e.a., *The interpretation of income tax treaties with particular reference to the Commentaries on the OECD Model,* Amsterdam, IBFD, 2005, 64 *et seq.*

b. Bundesfinanzhof 8 September 2010[2206]

This is a case were the influence of the ECJ's case law was very apparent and where the Court expressly recognized that influence. The taxpayer, a German resident company, paid interest to its Swiss resident shareholder. Because the requirements of the German thin cap rules as they applied at the time were not fulfilled in the years at issue (1999 to 2001), the interest was not deductible. Under those thin cap rules, interest was not deductible if it was paid to a shareholder who was not entitled to the German corporation tax credit (in 1999 and 2000) or to a shareholder who was not taxable in Germany on the interest received by way of assessment (in 2001)[2207]. It was clear that the conditions for the applicability of the thin cap rules were fulfilled, but the taxpayer argued that those rules constituted discrimination contrary to the ownership non-discrimination clause of the German/Swiss treaty[2208]. It should be noted at the outset that that treaty did not include a deductibility non-discrimination provision analogous to Art. 24(4) OECD MC.

The Bundesfinanzhof decided in favour of the taxpayer. The Court held that, by applying exclusively to payments made to shareholders not entitled to the corporation tax credit or not taxable in Germany by way of assessment, the German thin cap rules were "always and in particular" to the disadvantage of German companies the capital of which was held or controlled by non-residents. According to the Court, the fact that the actual distinguishing criteria used by those rules – i.e. the non-entitlement to the corporation tax credit or the absence of taxation by way of assessment – were not directly based on the shareholder's residence was irrelevant[2209]. Rather, it was necessary to fully take account of the parallel 'European' perspective with respect to the standard of comparison, as it emerged from the ECJ's decision in *Lankhorst-Hohorst*, and this irrespective of all other differences between the 'European' and tax treaty non-discrimination rules. In both cases, it was decisive that both the non-entitlement to the corporation tax credit and the absence of taxation by way of assessment primarily concerned non-resident shareholders[2210]. The Court therefore decided

[2206] BFH 8 September 2010, I R 6/09, *BFHE* 231, 75.
[2207] See also A. CORDEWENER, "Pending cases filed by German courts", in M. LANG (ed.), *Direct taxation: recent ECJ developments*, Vienna, Linde Verlag, 2003, 37-61, who gives a clear overview of the German thin cap rules as they applied when *Lankhorst-Hohorst* was pending before the ECJ.
[2208] Art. 25(3) of the 1971 treaty, which is identical to Art. 24(5) OECD MC.
[2209] BFH 8 September 2010, I R 6/09, para. 23: *"Damit werden stets und insbesondere diejenigen Unternehmen eines Vertragsstaats, deren Kapital ganz oder teilweise, unmittelbar oder mittelbar einer in dem anderen Vertragsstaat ansässigen Person oder mehreren solchen Personen gehört oder ihrer Kontrolle unterliegt, gegenüber entsprechenden Unternehmen mit im Inland ansässigen Anteilseignern steuerlich benachteiligt. Dass die tatbestandlichen Unterscheidungsmerkmale der fehlenden Anrechnungsberechtigung zur Körperschaftsteuer [...] bzw. der fehlenden Veranlagung [...] unmittelbar nicht auf die Ansässigkeit der Anteilseigner abstellen, tut insoweit nichts zur Sache."*
[2210] See C-324/00, *Lankhorst-Hohorst*, paras. 27-28: *"As regards the taxation of interest paid by subsidiary companies to their parent companies in return for loan capital, such a restriction introduces a difference in treatment between resident subsidiary companies according to whether or not their parent company has its seat in Germany. In the large majority of cases, resident parent companies receive a tax credit, whereas, as a general rule, non-resident parent companies do not. […] Corporations incorporated under German law which are exempt from corporation tax and, consequently, not entitled to tax credit are essentially legal persons governed by public law and those carrying out business in a specific field or performing tasks which should be encouraged. The situation of a company such as the parent company of Lankhorst-Hohorst, which is carrying on a business for profit and is subject to corporation tax, cannot validly be compared to that of the latter category of corporations."*

that the German rules gave rise to **direct** discrimination of Swiss-owned enterprises as compared to German-owned enterprises[2211].

Finally, the Court held that the fact that the German rules at issue could, in certain cases, also apply to German-owned enterprises, did not affect that conclusion. According to the purpose and objective of those rules, they applied primarily and in their actual effect to foreign-owned enterprises. As a result, the German thin cap rules fell foul of the ownership non-discrimination provision of the German/Swiss treaty[2212].

This decision is of particular importance because the Court expressly states that the comparison under Art. 24(5) should be interpreted identically to that under the fundamental freedoms. Clearly, the outcome of the case would have been different without this influence of the ECJ's case law. As discussed in Part II, 2.F.I.C, Art. 24(5) is only concerned with direct discrimination, i.e. discrimination 'on the basis of' foreign ownership. Here, the German rules mainly affected foreign-owned enterprises, but also some domestically-owned enterprises (e.g. tax exempt residents). Obviously, that is a case of indirect discrimination[2213], which goes beyond the scope of Art. 24(5) as it has traditionally been interpreted. Nevertheless, the Court states that there is discrimination because this aspect of the tax treaty non-discrimination clause should be given the same scope as the non-discrimination standard emerging from the fundamental freedoms.

As pointed out earlier, restricting a rule to cover only direct discrimination means that all relevant characteristics, apart from the comparative attribute, should be the same. Applied to Art. 24(5), that means that all relevant characteristics, apart from foreign ownership, should be the same. In the case at hand, the corporate status of the shareholder was not a relevant characteristic for the purpose of the German thin cap rules under scrutiny. As a result, a resident company with a non-resident corporate shareholder could validly be compared to a resident company with a resident non-corporate shareholder (e.g. a tax-exempt entity). But because the Court's analysis is influenced by the ECJ's case law, it implicitly considers that resident companies with a non-resident corporate shareholder can only validly be compared to resident companies with a resident corporate shareholder (rather than a resident tax-exempt entity). Arguably, that is what the Court means when it says that account should be taken of

---

[2211] BFH 8 September 2010, I R 6/09, para. 23: *"Vielmehr ist unbeschadet aller sonstigen Unterschiede zwischen den unionsrechtlichen Diskriminierungsverboten einerseits und den abkommensrechtlichen Diskriminierungsverboten andererseits jedenfalls in diesem Punkt vollumfänglich auf die insoweit – was den Vergleichsmaßstab anbelangt – parallele gemeinschaftsrechtliche Sicht zu verweisen[...], wie sie sich aus [...] Lankhorst-Hohorst [...] ergibt. Ausschlaggebend ist hier wie dort, dass sowohl von der fehlenden Nichtanrechnungsberechtigung als auch von der fehlenden Veranlagungsmöglichkeit vorrangig im anderen Vertragsstaat ansässige Anteilseigner betroffen sind und dadurch im Ergebnis eine diskriminierende Ungleichbehandlung von Kapitalgesellschaften mit in- und ausländischen Anteilseignern bewirkt wird. Damit ist die steuerliche Behandlung von Inlandsgesellschaften mit in der Schweiz ansässigen Anteilseignern i.S. von Art. 25 Abs. 3 DBA-Schweiz 1971/1992 --und zwar unmittelbar und nicht lediglich mittelbar-- anders oder belastender als die Besteuerung, denen [...] 'andere ähnliche Unternehmen' in Deutschland unterworfen sind oder unterworfen werden können."*

[2212] BFH 8 September 2010, I R 6/09, para. 23: *"Der Umstand, dass § 8a Abs. 1 Satz 1 Nr. 2 KStG 1999 a.F./n.F. in bestimmten Situationen gleichermaßen auch für Gesellschaften mit inländischen Anteilseignern einschlägig werden kann, tritt dahinter zurück; Zielrichtung der genannten Vorschriften zur steuerlichen Beschränkung der Gesellschafter-Fremdfinanzierung bei Kapitalgesellschaften ist nach Regelungssinn und -zweck in erster Linie und in der tatsächlichen Auswirkung die Erfassung grenzüberschreitender Sachverhalte der Gesellschafter-Fremdfinanzierung mit ausländischen Anteilseignern."*

[2213] For some reason, however, the Court nevertheless considers this to be a case of direct discrimination.

the 'European' non-discrimination rule **with respect to the standard of comparison** (*"was den Vergleichsmaßstab anbelangt"*).

Unfortunately, the Court does not address in detail why such a parallel interpretation is necessary. It only states that, irrespective of any other differences with the 'European' standard (which implies that there are certain aspects which are not suited for a parallel interpretation), it is necessary to fully take account of the 'European' perspective which is parallel to the tax treaty perspective with respect to the standard of comparison (*"Vielmehr ist [...] jedenfalls in diesem Punkt vollumfänglich auf die insoweit – was den Vergleichsmaßstab anbelangt – parallele gemeinschaftsrechtliche Sicht zu verweisen"*).

c. Dutch Supreme Court 8 February 2002

In this case, which was discussed in Part II, 2.D.III.C.d.2, the Court was also inspired by the ECJ's case law in interpreting Art. 24. In particular, when the Court (implicitly) held that Art. 24(3) of the Dutch/Swiss treaty required Switzerland to extend the relief granted under the Japanese/Swiss treaty to the Swiss PE of a Dutch resident, it expressly referred to the ECJ's decision in *Saint Gobain*[2214]. But the Court does not clarify **why** it refers to *Saint Gobain*.

In any event, the reasoning developed in *Saint Gobain* cannot be transposed to the traditional interpretation of Art. 24(3) (see Part II, 2.D.III.C.d.2). Given the principle of reciprocity, Art. 24(3) as it has traditionally been interpreted does not require the PE State to extend the benefits of treaties concluded with third States to PE's situated in its territory. So the Dutch Supreme Court does not draw a mere analogy between Art. 24(3) and the fundamental freedoms. Rather, it seems that its interpretation of Art. 24(3) was directly influenced by the ECJ's case law, in particular *Saint Gobain*. Apparently, the Supreme Court considers that, because the fundamental freedoms require relief granted under a treaty with a third State to be extended to PEs, Art. 24(3) should require the same. Unfortunately, the Court does not clarify **why** the case law of the ECJ should affect the interpretation of Art. 24(3).

d. Verwaltungsgerichtshof 16 February 2006

This case was already discussed in Part II, 2.D.II.B.a.5. As pointed out there, the Court took the head office's tax position into consideration in applying Art. 24(3) to a domestic measure that denies non-residents' PEs the possibility to carry forward losses. If the Court did so as an aspect of its comparability-analysis, the decision would deviate from the majority opinion on Art. 24(3), according to which the subject of comparison should be considered in isolation, without interference from the head office's tax position. That was, for instance, the position taken by the Bundesfinanzhof in its decision of 22 April 1998 (see Part II, 2.D.II.B.a.4), concerning a domestic rule that was similar to the rule at issue here. The Bundesfinanzhof expressly held that it was irrelevant that the PE losses could possibly also be taken into account at the level of the head office. Apparently, the Verwaltungsgerichtshof decided differently because it was influenced by the ECJ's case law on the risk that losses may be

---

[2214] Para. 3.6 of the decision: *"een verrekening van de over dit gedeelte van de royalty's ingehouden bronbelasting met de in Nederland verschuldigde vennootschapsbelasting […] zou ook niet sporen met het streven verrekening van de buitenlandse bronheffing te laten plaatsvinden met de belasting die de vaste inrichting verschuldigd is in het land waarin deze zich bevindt (vgl. het arrest van het Hof van Justitie van de Europese Gemeenschappen van 21 september 1999, zaak nr. C-307/97 (Saint-Gobain), BNB 2000/75)."*

used twice (particularly *Marks & Spencer*). Because there was no such risk in the case at hand, the Court held that the denial of the loss carry-forward for the PE constituted discrimination.

As argued in Part II, 2.D.II.A.a, all the characteristics that are relevant for the purposes of the domestic measure under scrutiny should be taken into consideration when constructing the subject and object of comparison under Art. 24(3). In principle, there is no reason why the head office's tax position cannot constitute such a relevant characteristic from the perspective of the taxation of the PE.

Could the decision of the Verwaltungsgerichtshof be interpreted that way? More specifically, the Austrian measure at issue denied the possibility to carry forward losses insofar as those losses could be absorbed by the head office. Could it be said that, because the possibility for the PE to carry forward losses depends on the question whether the head office can deduct those losses, the tax position of the head office is a relevant characteristic for the purposes of the taxation of the PE? If so, the head office's tax position would have to be taken into account when constructing the subject of comparison, as described in Part II, 2.D.II.B.a.5. More specifically, if the head office cannot deduct the losses (as was the case in the decision discussed here), the appropriate subject of comparison would be the Austrian PE of a non-resident company that cannot deduct the losses at the level of the head office. From such an overall perspective, the subject of comparison is treated less favourably than the object of comparison (a resident company that is entitled to the carry forward) with the result that there is discrimination. On the other hand, if the head office can deduct the losses, the appropriate subject of comparison would be the Austrian PE of a non-resident company that can deduct the losses at the level of the head office. In that case, the subject of comparison is not treated less favourably than the object of comparison with the result that there is no discrimination.

In my opinion, that is not the correct approach. The disadvantage at issue was precisely that the PE could only carry forward losses if those losses could not be taken into account at the level of the head office. So the less favourable treatment in question was that an additional condition was imposed on PEs wishing to carry forward losses, namely that the losses cannot be taken into account by the foreign head office. Considering the head office's tax position to be a relevant characteristic for that reason would severely restrict the scope of application of Art. 24(3).

In order to illustrate why this is so, it must be stressed that the subject of comparison under Art. 24(3) is the PE which an enterprise of one contracting State has in the other contracting State. Here, the disadvantage suffered by that subject of comparison is that it must meet an additional condition before it can carry forward losses (namely the condition that those losses cannot be taken into consideration by the head office). In contrast, the object of comparison – a resident enterprise – can carry forward losses without meeting such an additional condition. Clearly, the mere fact that the subject of comparison's head office can deduct the losses cannot render these situations incomparable. Obviously, there may be other reasons why the head office's **is** a relevant characteristic from the perspective of the domestic measure under scrutiny, but that is not the point here. What is at issue here is that a State cannot argue that the tax position of the head office is relevant on the mere basis that the distinction made by that measure (also) takes account of the head office's tax position.

To take a simpler example, assume that a contracting State grants a tax benefit to its nationals, while this benefit is granted to non-nationals only if they are female. If a male non-national challenges this distinction by invoking the nationality non-discrimination clause, could the State in question say that there is no discrimination because a male non-national is not comparable to a national? More specifically, could that State argue that gender is a relevant characteristic because the domestic measure at issue refers to gender? I do not consider that to be a valid argument. The disadvantage suffered by non-nationals is precisely that they must meet an additional requirement to qualify for the benefit, namely that they must be female. Clearly, the non-fulfilment of that requirement cannot be invoked to argue that the situations are incomparable.

> This discussion is related to an issue that was addressed earlier, namely the question whether Art. 24 OECD MC requires the discrimination to be ‘on the sole basis of’ the prohibited criterion (see Part II, 2.B.V.C and Part II, 2.F.I.C). As pointed out there, requiring the distinction at issue to be made ‘solely’ on the basis of the prohibited criterion (i.e. nationality under Art. 24(1), foreign ownership under Art. 24(5)) would unduly restrict the scope of application of the non-discrimination provision. The same applies to Art. 24(3). It would be overly restrictive to limit the application of that provision to situations where a distinction is made solely on the basis of the fact that the taxpayer is not a resident of the source State but a non-resident with a PE in the source State. For instance, in the case discussed here, the loss carry-forward was not only denied on the basis that the taxpayer was not a resident, but also on the basis that the PE’s head office could deduct the losses. But that does not mean that Art. 24(3) cannot be applied.
>
> Of course, the analysis does not end there. The next question is whether the fact that the PE’s head office can deduct the losses is a relevant characteristic that renders the subject of comparison (a non-resident with a PE in the source State) incomparable to the object of comparison (a resident enterprise). And that is the issue discussed here. In particular, the question addressed here is whether the fact that the availability of the loss carry-forward depended on the possibility for the head office to deduct those losses means that the head office’s tax position is a relevant characteristic when constructing the subject and object of comparison. As discussed here, that is not the case because the disadvantage consisted precisely of that additional condition applying to non-residents’ PEs wishing to carry forward losses[2215].

As a result, it does not seem likely that the Verwaltungsgerichtshof took the head office’s tax position into account as an aspect of the comparability-analysis. Rather, the Court seems to consider that the possibility that losses may be used twice constitutes a possible justification for discriminatory treatment. Even though the measure treats comparable situations differently contrary to Art. 24(3), the Court verifies whether the challenged discrimination is justified because the domestic measure sought to achieve a legitimate objective, namely the need to prevent that losses are deducted twice. That interpretation also seems more plausible from the perspective of the ECJ’s *Marks & Spencer* decision, which influenced the Court’s conclusion (see supra). In that case as well, the risk that losses are used twice is considered as a justification ground[2216].

[2215] A similar approach could be taken with respect to the case decided in 1993 by the Swedish Supreme Administrative Court (see Part II, 2.F.I.C.d). There, it was clear that the mere fact that the domestic measure at issue referred to the place of residence of the transferee’s shareholder did not mean that that was a relevant characteristic which was able to render the situations incomparable. In particular, the disadvantage at issue in that case was that the subject of comparison had to meet an additional condition in order to benefit from the group contribution regime, namely the condition that the transferee’s shareholder had to be a resident. As a result, it cannot be argued that the transferee’s shareholder’s place of residence is a relevant characteristic that renders the situations incomparable simply because the domestic rule distinguishes on that basis.

[2216] C-446/03, *Marks & Spencer*, § 47-48.

At first glance, this has the remarkable result that, in respect of the loss carry-over system at issue here, the taxpayer's protection under Art. 24(3) seems to decrease because of the influence from the ECJ's case law. As mentioned repeatedly, Art. 24 does not offer the possibility to justify discriminatory measures. So it seems that the influence of the ECJ's case law on the interpretation of Art. 24 OECD is that the protection offered to taxpayers by that provision is scaled back by giving Member States a let-out for discriminatory measures. More specifically, when there is a possibility that the losses are deducted twice, the PE State may deny the benefit of the carry-over. Even though there is discrimination, the domestic measure is upheld because of a reason of general interest.

e. The Delaware case

This case was already discussed in Part II, 2.F.III.B.a. As noted there, the Bundesfinanzhof's decision that the ownership non-discrimination clause of the German/U.S. treaty required the Organschaft regime to be applied was inspired by the ECJ's decision in *Überseering*. In particular, the BFH held that, given the evolution in the ECJ's case law, it could no longer be maintained that the U.S. parent could not qualify as 'Organträger' for purposes of the German Organschaft regime. The BFH recognized that ECJ decisions are only directly relevant and binding for EU Member States, with the result that legal persons of third States cannot invoke such decisions in order to claim equal treatment with residents of EU Member States. However, the situation was different for a U.S. corporation because of the ownership non-discrimination clause in the German/U.S. treaty. Pursuant to that provision, domestic subsidiaries of U.S. corporations could not be treated less favourably than similar domestic subsidiaries of German companies. For that reason, U.S.-owned resident companies could not be treated less favourably than companies within the EU[2217].

At first glance, the wording used by the BFH seems to suggest that the 'national treatment' to which foreign-owned enterprises should be entitled under Art. 24(5) OECD MC also covers tax benefits granted pursuant to European tax law (including the ECJ's decisions). But as pointed out in Part II, 2.F.III.B.a, that interpretation is not very convincing. Rather, it seems that the BFH interprets the ownership non-discrimination clause **in line with** the ECJ's interpretation of the fundamental freedoms. In other words, the BFH considers that, because the ECJ would strike down the distinction made by the German rules in an EU context, the same should be true under Art. 24(5) in a non-EU context[2218]. As in the cases discussed

[2217] BFH 29 January 2003, I R 6/99, para. 2: *"Die Versagung der Organträgereigenschaft für die B-Inc. verstößt jedoch gegen das Diskriminierungsverbot des Art 24 Abs 4 des [...] DBA-USA 1989. Die noch in dem vorgenannten Senatsbeschluss vertretene, anderweitige Auffassung lässt sich in Anbetracht der zwischenzeitlichen Rechtsentwicklung nicht aufrechterhalten, nachdem der [...] EuGH durch Urteil vom 5 November 2002 Rs C-208/00 Überseering [...] in der sog Sitztheorie bei Zuzugsfällen eine Verletzung der Niederlassungs- und der Kapitalverkehrsfreiheit [...] gesehen hat. Die Entscheidung wirkt sich zwar unmittelbar nur auf die EG-Mitgliedsstaaten aus. Juristische Personen anderer (Dritt-) Staaten können im Hinblick darauf keine Gleichbehandlung mit Angehörigen der Mitgliedsstaaten einfordern. Wegen des in Art 24 Abs 4 DBA-USA 1989 enthaltenen bilateralen Diskriminierungsverbots verhält es sich für eine US-Kapitalgesellschaft jedoch anders. Besteuerungsnachteile inländischer Tochterunternehmen von US-amerikanischen Unternehmen gegenüber anderen ähnlichen inländischen Unternehmen sind hiernach nicht hinzunehmen und können deswegen im Ergebnis keiner für sie ungünstigeren Beurteilung als Unternehmen innerhalb der EG unterfallen."*

[2218] E.g. G. TOIFL, "Gemeinschaftsrechtskonforme Interpretation der DBA-rechtlichen Diskriminierungsverbote", *SWI* 2004, 325: *"Diese bezugnahme auf die Rechtsprechung des EuGH zu den gemeinschaftlichen Grundfreiheiten indiziert, dass der BFH an seiner bisherigen Rechtsprechung eines unterschiedlichen Inhalts der gemeinschafts- und abkommensrechtlichen Diskriminierungsverbote nicht mehr festhalten will"*. Similarly, D. GOSCH, "Vielerlei Gleichheiten – Das Steuerrecht im Spannungsfeld von above, however, the BFH does not give any reason **why** the tax treaty non-discrimination provision should be interpreted in line with the fundamental freedoms.

f. Conclusion

All of the cases discussed here were decided in the past decade. Even though the number of cases where the influence of the ECJ's case law on the interpretation of the tax treaty non-discrimination provisions is still quite modest, this may indicate that courts in EU Member States are gradually growing aware of the necessity of an analogous interpretation of both standards. Unfortunately, none of the cases discussed here offers any guidance on **why** these courts consider such an influence to be necessary.

The next section will address whether there are legal arguments for allowing the interpretation of Art. 24 OECD MC to be influenced by the ECJ's case law on the fundamental freedoms.

II. Should the interpretation of Art. 24 be influenced by the ECJ's case law?

The case law discussed above shows that the ECJ's case law does have some influence on the interpretation given to Art. 24 OECD MC by national courts of EU Member States, particularly in the last decade. This raises the question whether such an influence is appropriate. On this point, opinions are somewhat divided. For instance, the European Commission has published a working document on the interaction between EU law and tax treaties[2219], which also addresses the question as to whether the non-discrimination provision in tax treaties should be interpreted in accordance with the case law developed by the ECJ. In

---

bilateralen, supranationalen und verfassungsrechtlichen Anforderungen", *Deutsches Steuerrecht* 2007, 1560: *"EG- und DBA-Diskriminierungsverbote stehen als unterschiedliche Rechtskreise nebeneinander. Beide Rechtskreise enthalten auch unterschiedliche Anforderungen an die Schutzintensität. [...] Dennoch: Es kann zu tatbestandlichen Überschneidungen kommen, die eine Drittstaatenwirkung erzwingen. [...] Auch dann, wenn der EG-rechtliche Schutz über denjenigen des Abkommens hinausgeht, spricht viel dafür, die EG-Gleichbehandlungsgebote in die Abkommens-Diskriminierungsverbote einfließen zu lassen. Die Abkommens-Diskriminierungsverbote wären dafür zu 'materialisieren': Nicht nur die darin vorgegebenen Differenzierungskriterien würden sich diskriminierend auswirken, auch versteckte Diskriminierungen wie im Gemeinschaftsrecht. Auf der anderen Seite wäre der Absolutheitsanspruch der abkommensrechtlichen Diskriminierungsverbote zu relativieren und an den Rechtfertigungsgründen des EuGH zu messen. Der I. Senat des BFH hat einen ersten Schritt in diese Richtung einer wechselseitigen Verschränkung der Diskriminierungsverbote jedenfalls schon getan. Er hat in seinem sog. Delaware-Urteil vom 29.1.2003, I R 6/99, zur Zulässigkeit grenzüberschreitender Organschaftsverhältnisse gemeinschaftsrechtliche Gleichheitsanforderungen mit Art. 24 DBA-USA verknüpft und dies erklärtermaßen auf die Überseering-Entscheidung des EuGH gestützt."* On the other hand, the circular of the German Ministry of Finance, referred to above, points out that the BFH's decision does not imply that the tax treaty non-discrimination clause and the prohibition of discrimination under the fundamental freedoms offer the same protection. The tax treaty contains an exhaustive list and description of possible cases of discrimination, whereas the reason for the difference in treatment does not matter under the freedoms (Bundesministerium der Finanzen, "Diskriminierungsverbote der Doppelbesteuerungsabkommen; BFH-Urteil vom 29. Januar 2003", *BstBl* I 2004, 1181: *"Aus dem Urteil können keine, über den entschiedenen Sachverhalt hinausgehende Folgerungen für die Anwendung der DBA-Diskriminierungsverbote hergeleitet werden. Insbesondere sind die Diskriminierungsverbote der DBA und des EGV nicht deckungsgleich. Die DBA enthalten eine abschließende Aufzählung und Umschreibung möglicher Diskriminierungstatbestände, während es für den Diskriminierungsschutz nach dem EGV auf den Grund der Ungleichbehandlung nicht ankommt"*).

[2219] Commission Staff Working Paper, SEC(2001) 1681, "Company taxation in the Internal Market", 385.

particular, it points out that Art. 24 OECD MC *"should reflect the fundamental non-discrimination principles of the Treaty."* According to the working document, this may imply: *"- equating nationality with residence,*
- treating permanent establishments in the same way as resident subsidiaries,
- requiring provisions available to groups of companies within a Member State to be applicable where one of the members of the group is resident in another EU Member-State."

Additionally, *"any statement that anti-abuse legislation is not prohibited under this Article would have to reflect the restrictions on anti-abuse legislation to be inferred from the EC Treaty. Any other special rules added by Member States in Article 23 and 24 to govern the taxation of income which has been taxed at a low-rate in another country would have to aligned with the Treaty."*

The OECD Discussion Draft on Article 24 also addresses this issue[2220]. Under the heading "Issues that require a more fundamental analysis", the following four observations are made. First, courts, primarily in EU States, might be tempted to extend to the interpretation of Article 24 some of the principles developed by the ECJ. Secondly, it could be argued that Article 24 can result in an indirect application of provisions of the EU Treaty to residents of non-EU Member State. As a result, EU Member States that have introduced specific rules for nationals of EU Member States might be forced to extend these rules to nationals of States with which they have a tax treaty including a nationality non-discrimination provision. Thirdly, the Discussion Draft notes that it might be useful to consider some of the concepts and arguments developed under European law, e.g. the concept of justification, when discussing the desirability of alternative or additional non-discrimination rules for tax treaties. Finally, there might be more technical issues where the impact of European law on the interpretation of Article 24 is unclear and should be examined.

So the working document published by the European Commission takes the position that Art. 24 OECD MC should be interpreted in accordance with the ECJ's case law under the fundamental freedoms. The OECD Discussion Draft is less conclusive and merely points out that, in practice, there may be an influence but that there should be further research to determine whether such influence is desirable.

First of all, it should be stressed that the question to be addressed here is not whether one standard should yield to the other if there is a conflict between them. If a national measure is found not to infringe a tax treaty non-discrimination provision, that does not mean that it can no longer be considered incompatible with the fundamental freedoms. *Vice versa*, if a national measure is held to be compatible with the fundamental freedoms, it is still possible that it infringes the tax treaty non-discrimination provision. Since both standards simply say what is prohibited, the conclusion that a national measure is not prohibited by one standard does not affect the analysis under the other standard. So there is no actual conflict in the application of both standards.

What is at issue here is whether the interpretation of the tax treaty non-discrimination provision should be affected by the interpretation given to the fundamental freedoms by the ECJ. More specifically, are there legal arguments that require national courts of EU Member States to take account of the ECJ's case law on the fundamental freedoms when interpreting a tax treaty non-discrimination clause? According to VOGEL, that is not the case: *"Several*

[2220] OECD, "Application and interpretation of Article 24 (non-discrimination). Public discussion draft", 3 May 2007, 29.

reasons militate ***against applying*** *the ECJ case law regarding Art. 6 of the EC Treaty to the interpretation of Art. 24 MC […]. In particular, the different functions of the two provisions must be considered. Whereas non-discrimination plays a central part in helping the EC advance towards its economic goal […] of reaching a European Single Market, Art. 24 MC is one of the special rules of the MC which is not necessary to achieve the primary treaty-goal of avoiding double taxation and preventing tax evasion. This leads to a more narrow interpretation of the rule. Further, the MC lists in detail the cases in which it forbids discrimination based on residence, whereas under the EC Treaty the entire protection from discrimination must be derived from the criterion 'nationality'. […] Finally, the higher importance of Anglo-American legal principles for the interpretation of Art. 24 MC must be considered, particularly for the case of discrimination against juridical persons"*[2221].

These three reasons do not seem to be entirely convincing. First, the objective of Art. 24 and the fundamental freedoms is quite comparable: both rules seek to promote economic integration by removing discriminatory tax obstacles (see supra). Secondly, it is true that the scope of Art. 24 is much narrower, in that it expressly lists the situations in which it can be applied, but that does not mean that the principle underlying it is different from the principle underlying the fundamental freedoms. So that different scope does not imply that the interpretation of the former should not be influenced by that of the latter. Finally, it is not clear to me why or how Art. 24 is characterized by a 'higher importance of Anglo-American legal principles'. And even if it is, why should that prevent national courts of EU Member States from being influenced by the ECJ's case law?

That being said, it is more important to find arguments **in favour of** an interpretation of Art. 24 in accordance with the ECJ's case law than to find arguments against such an interpretation. As noted above, a parallel application of both provisions does not give rise to any apparent conflict, so there is no reason why both provisions cannot co-exist side-by-side without influencing each other. It would only be appropriate to allow the interpretation of Art. 24 to be influenced by the ECJ's case law if European tax law **requires** there to be such an influence. If not, there are no reasons why the interpretation given to Art. 24 by national courts of EU Member States should deviate from that given by other national courts. Indeed, it would be preferable for national courts to give a uniform interpretation to tax treaty provisions on the basis of the Commentary, thereby ensuring consistent case law and (thus) legal certainty for the taxpayer.

In other words, the issue is not whether Article 24 is incompatible with the fundamental freedoms, but what happens when Art. 24 **allows** (but does not require) a Member State to adopt a national measure which is incompatible with the fundamental freedoms. That is to say, since the fundamental freedoms offer broader protection against discrimination, it is likely that a national measure does not infringe Art. 24 while at the same time infringing the freedoms. The issue to be addressed here is whether European law requires Art. 24 to be interpreted in such a way as to prohibit such a national measure. In order to illustrate this, reference can be made to the *Evans Medical* case[2222], which concerned the prohibition to import diamorphine (an opium derivative) into the U.K. The applicant, a U.K. pharmaceutical company, argued that this prohibition infringed the free movement of goods. The ECJ acknowledged that the prohibition imposed by the U.K. restricted the free movement of goods. However, the 1961 Treaty on Narcotic Drugs, to which the U.K. was a party, allowed contracting States to prohibit importation of narcotic drugs into their territory, but did not

[2221] K. VOGEL, *o.c.*, 1283 (emphasis in original text).
[2222] C-324/93, *Evans Medical Ltd*, 28 March 1995.

require them to adopt such measures. On that point, the ECJ held: *"when an international agreement allows, but does not require, a Member State to adopt a measure which appears to be contrary to Community law, the Member State must refrain from adopting such a measure"*[2223]. As a result, the prohibition infringed the free movement of goods, even though it was allowed by the 1961 Treaty.

This is precisely the issue under analysis here: an international agreement allowed (but did not require) the U.K. to adopt a national measure, but that national measure was incompatible with the fundamental freedoms. It is important to note that the ECJ does **not** say that the provisions of the 1961 Treaty should be interpreted in accordance with the free movement of goods. The Court only states that the free movement of goods precludes a measure which prohibits the importation of certain goods, even if such a prohibition is allowed by a treaty to which the contracting State in question is a party. So this is not a matter of interpreting an international tax treaty in accordance with European law, but of striking down a national measure that infringes the free movement provisions (even though it is allowed by the treaty).

So the core issue is whether there are principles of European law which require Art. 24 to be interpreted in accordance with the ECJ's case law. Could it be said, first of all, that this is required by the principle of loyal cooperation, as provided for in Art. 4(3) TEU (former Art. 10 EC)? Loyal cooperation implies two obligations for the Member States: (1) to take all appropriate measures to ensure fulfilment of the obligations arising out of the Treaties or resulting from the acts of the institutions of the Union (positive loyalty) and (2) to refrain from any measure which could jeopardise the attainment of the Union's objectives (negative loyalty). The latter, negative, obligation is of little use in the present discussion. Indeed, if a national court finds that a domestic measure does not infringe a tax treaty non-discrimination clause, then that conclusion does not say anything about the measure's compatibility with the fundamental freedoms (see supra). The same national court is still free to declare the domestic measure incompatible with the fundamental freedoms. So it cannot be said that that court acts in a disloyal manner and jeopardizes the attainment of the Union's objectives. Interpreting the tax treaty non-discrimination clause in a restrictive manner does not have any impact on the effectiveness of EU law in that respect. As long as the national court interprets the fundamental freedoms correctly (i.e. in line with the ECJ's case law), it gives proper effect to EU law.

The conclusion may be different with respect to the positive aspect of loyalty. The ECJ has held that this positive aspect requires all national authorities, including national courts, to interpret national law in the light of the wording and purpose of EU law[2224]. It also precludes national courts from adopting judgments that conflict with judgments of the ECJ[2225]. Perhaps, it could be argued that this obligation also extends to the interpretation of tax treaties. As a result, it could be said that a loyal interpretation of the fundamental freedoms require national courts of EU Member States to interpret Art. 24 OECD MC in accordance with the ECJ's case law (see also hereafter, on effet utile). However, such an interpretation probably goes beyond what EU loyalty seeks to ensure. It is true that national law must be interpreted in a way that is consistent with EU law. As a result, domestic measures that are inconsistent with the

[2223] C-324/93, *Evans Medical Ltd*, § 32. Similarly, C-124/95, 14 January 1997, *Centro-Com Srl*, § 60.
[2224] E.g. Case 14/83, *Sabine von Colson and Elisabeth Kamann*, 10 April 1984, para. 26; C-106/89, *Marleasing*, 13 November 1990, para. 8. See also Case 106/77, *Simmenthal*, 9 March 1978, para. 17.
[2225] See J. LANG, "Article 10 EC – The most important 'general principle' of Community law", in U. BERNITZ, J. NERGELIUS and C. CARDNER (eds.), *General principles of EC law in a process of development*, Alphen aan den Rijn, Kluwer Law International, 2008, 91.

fundamental freedoms should be struck down by national courts and national courts should thereby follow the ECJ's judgments. But that does not mean that national courts are under an obligation to interpret every international treaty that allows such a domestic measure in accordance with the ECJ's case law. It is national law, not the treaty, which creates the incompatibility with EU law. So the principle of loyalty requires the national measure to be struck down, but it does not say anything about treaties that allow such a measure.

The principle of EU loyalty is also the basis for a second principle to be addressed here, namely the principle of effectiveness of EU law ('effet utile')[2226]. Could it be said that this principle of effectiveness requires an interpretation of Art. 24 in accordance with the ECJ's case law? An important aspect of that principle is that EU law must have primacy over any level of national or bilateral law of the Member States[2227]. But, once again, this is of little relevance when there is no conflict between the two sources of law. As noted above, declaring a national measure to be compatible with the non-discrimination provision in a tax treaty does not say anything about that measure's compatibility with the fundamental freedoms.

However, another aspect of the principle of effectiveness is that national law must be interpreted in conformity with EU law (the consistent interpretation principle)[2228]. Accordingly, when interpreting national law, national courts must do so in light of the wording and the purpose of EU law in order to achieve the result pursued by the latter. In other words, where two interpretations are possible, one of which is in conformity with EU law while the other is not, the consistent interpretation principle requires the former interpretation to be applied. Applied to Art. 24 OECD MC, it could be said that national courts are under an obligation to interpret that provision in a manner which ensures that the objective pursued by the fundamental freedoms is attained. And in order to do so, account should be taken of the ECJ's case law on the interpretation of those freedoms. Since this is quite similar to the argument made above, with respect to the positive aspect of the principle of EU loyalty, it should be dismissed for the same reason. It is true that the consistent interpretation principle requires that domestic measures which are incompatible with the fundamental freedoms are struck down, but that does not mean that the interpretation of a treaty allowing such a domestic measure should be affected.

A third possible argument is that resolving an issue under Art. 24 by interpreting that provision in accordance with the ECJ's case law squares better with the subsidiarity principle than resolving the issue under the free movement provisions[2229]. According to Art. 5 TEU (former Art. 5 EC), the principle of subsidiarity means that, in areas which do not fall within its exclusive competence, the Union shall act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level. Since direct taxation is an area which does not fall within the exclusive competence of the Union, the objective of realizing an internal market – which underlies the fundamental freedoms – should be achieved at the level of the Member States where possible. Could it be said that this principle requires national courts of Member States to interpret Art. 24 in line with the ECJ's case law, on the basis that the objectives of the fundamental freedoms should be achieved by national or bilateral instruments where possible, and only by EU instruments where necessary? I do not think that is an appropriate interpretation of the subsidiarity principle.

[2226] See J. LANG, *o.c.*, 76.
[2227] E.g. Case 6/64, *Costa v E.N.E.L.*, 15 July 1964.
[2228] E.g. C-91/92, *Faccini Dori*, 14 July 1994, para. 26; C-160/01, *Mau*, 15 May 2003, para. 34-36.
[2229] M. LEHNER, "Der Einfluss des Europarechts auf die Doppelbesteuerungsabkommen", *IStR* 2001, 337.

This principle governs the relationship between the institutions of the Union and the Member States, that is to say, it limits the extent to which those institutions can exercise their competence[2230]. More specifically, it states that the institutions of the Union only act where the objective in question can be better achieved at the Union level. But it does not say anything about the relationship between two different legal sources (i.e. a tax treaty and the fundamental freedoms) when a matter is brought before a national court of a Member State. After having decided that a national measure is compatible with Art. 24, there is nothing to preclude the national court from declaring that measure incompatible with the fundamental freedoms. This has nothing to do with subsidiarity: there is no doubt in such a situation as to whether the matter should be addressed at the Union level or at the Member State level.

So the main problem in applying these general principles to the issue at hand is that there is no incompatibility between the tax treaty and the fundamental freedoms[2231]. The principles described above mostly concern the situation where there is a conflict between national or bilateral law on the one hand and EU law on the other hand. But that is not the case where Art. 24 is concerned. The problem is not that the non-discrimination provision of a tax treaty is incompatible with EU law, but that a national measure is **not** incompatble with Art. 24 while it is possibly incompatible with the fundamental freedoms. Clearly, that is not a matter of conflicting rules so the principles described here are not very helpful.

To summarize, it does not seem that European law requires the non-discrimination provision in tax treaties to be interpreted in accordance with the ECJ's case law on the fundamental freedoms. It could be said that such a parallel interpretation is required by the 'consistent interpretation' aspect of the principle of effectiveness (and, related thereto, the positive aspect of the loyalty principle), but so far this seems rather theoretical. Ultimately, there is no conflict between the two standards so there is no real reason why there should be any influence. If a matter is governed by both a tax treaty non-discrimination provision and the fundamental freedoms, it is not problematic to interpret both standards separately in their appropriate legal framework. If a matter is governed by only one standard, there is nothing to require that the other standard is also taken into account in the interpretation process. Additionally, as noted above, it would be preferable from the perspective of legal certainty that nationals courts worldwide interpret Article 24 uniformly, without being influenced by regional particularities.

[2230] K. LENAERTS and P. VAN NUFFEL, *Constitutional law of the European Union*, Sweet & Maxwell, London, 2005, 101.

[2231] For this reason, it is not necessary to distinguish between tax treaties concluded before and after the Member State in question acceded to the EU. According to Art. 351 TFEU (former Art. 307 EC), *"the rights and obligations arising from agreements concluded before 1 January 1958 or, for acceding States, before the date of their accession, between one or more Member States on the one hand, and one or more third countries on the other, shall not be affected by the provisions of the Treaties. To the extent that such agreements are not compatible with the Treaties, the Member State or States concerned shall take all appropriate steps to eliminate the incompatibilities established."* Since there is no incompatibility between the obligations imposed by the tax treaty and those imposed by the fundamental freedoms, this distinction is irrelevant.

Part V: Summary and general conclusions

The objective of this study was twofold. The first objective was to give a clear and thorough overview of the interpretation of Article 24 OECD MC and the ECJ's case law on the fundamental freedoms as applied to matters of direct taxation. The second objective was to determine whether there is a uniform principle of non-discrimination that underlies both standards.

1. Analysis of the two standards

With respect to the first objective, a distinction was made according to the dichotomy that is inherent in the Aristotelian understanding of non-discrimination: (1) the empirical assessment that two situations are comparable and (2) the normative conclusion therefrom that those situations must be treated identically. Additionally, the analysis of Article 24 OECD MC was carried out according to the structure of the provision, i.e. the different types of discrimination which Art. 24 seeks to prevent. Similarly, the standard developed by the ECJ was analysed by distinguishing between different types of discrimination identified by the Court.

A. Article 24 OECD MC

The history of the development of Article 24 shows that the provision was included in the OECD MC without much consideration as to its precise purpose and practical applicability. The underlying reason for including a non-discrimination provision in tax treaties seems to be that tax discrimination hampers international development, and that preventing such discrimination would stimulate reciprocal trade. Additionally, the drafters of the Model did not seem to expect that Article 24 would have a significant impact on the tax systems of the (then) OEEC Member States. After the publication of the 1963 OECD Draft Convention, the text of Article 24 has not been altered drastically. The only important changes have been the removal of the nationality definition, the inclusion of a paragraph on discrimination concerning the deductibility of payments and the addition of the expression *"in particular with respect to residence"* in Art. 24(1).

As a general point of criticism, attention was drawn to the wording of Article 24 OECD MC, which is characterised by a lack of clarity and may therefore give rise to some confusion. For instance, the meaning of the term 'an enterprise' in Art. 24(3), (4) and (5) is far from clear. It would be preferable to have a workable definition of this term, or to use a different term altogether. Moreover, some thought was given to the concept of reciprocity in the context of Article 24 OECD MC. It was concluded that this concept should not be understood as a licence for a contracting State that feels its subjects are being discriminated against by the other contracting State, to apply retaliatory discrimination to the subjects of the latter State. Instead, reciprocity implies that both contracting States should ensure that taxpayers of the other State have the possibility to effectively challenge discriminatory tax measures before the competent courts of the (allegedly) discriminating State.

As to the actual application of Article 24 OECD MC, the analysis of case law has shown that the same three steps should always be taken when applying the different paragraphs: (1) is the taxpayer entitled to protection under Article 24, (2) is the subject of comparison comparable to the object of comparison and (3) is the subject of comparison treated less favourably (or differently) as compared to the object of comparison. There is only discrimination contrary to Article 24 if the answer to those three questions is in the positive.

With respect to the first question, Article 24 is quite narrow. The taxpayer can only rely on Article 24 if he falls within one of the five categories listed in the provision. Furthermore, Article 24 only applies to cases of direct discrimination. On the other hand, Article 24(1) states that it applies to nationals of the contracting States, even if they are not residents of either contracting State. Additionally, Article 24(6) provides that Article 24 applies to taxes of every kind and description.

In this respect, it was also noted that the OECD Commentary is sometimes overly restrictive as regards the scope of application of Article 24. The most notable example is the Commentary's position on group taxation regimes in the context of Art. 24(5). According to the Commentary, that paragraph only relates to the taxation of the foreign-owned resident. As a result, it does not apply to group regimes since that would require considering the combined treatment of the group rather than the treatment of the foreign-owned resident in isolation. It has been submitted, however, that that approach is not very convincing since there are group taxation regimes (e.g. measures allowing loss transfers between subsidiaries of a common parent company) that are solely concerned with the taxation of a resident enterprise. There is no reason not to apply Art. 24(5) to such domestic measures.

The second question, concerning comparability, is essentially the same under the five paragraphs of Article 24 OECD MC. The decisive question is always which characteristics are relevant from the perspective of the domestic measure under scrutiny. Article 24(1), (2) and (3) expressly refer to characteristics that should be taken into account in constructing the comparison, i.e. residence for paragraph 1 and 2 and the type of activities carried out for paragraph 3. However, it has been submitted that the decisive question is always whether a given characteristic is relevant. It is impossible to state beforehand that a certain characteristic (e.g. residence) will always be relevant for the purposes of constructing the comparison under one of the paragraphs of Article 24. Whether a given characteristic is relevant depends entirely on the domestic legislation which is tested against Article 24. Additionally, when a relevant characteristic is inherent in the comparative attribute, it should be disregarded. Otherwise, the subject and object of comparison would be incomparable by definition, which would render Article 24 practically meaningless.

Finally, the question whether the subject of comparison is treated less favourably (or differently) as compared to the object of comparison is also the same under the different paragraphs of Article 24. Counterbalancing advantages, whether in the contracting State whose tax regime is under scrutiny or elsewhere, do not remove the discrimination. Accordingly, it is necessary to consider the domestic measure at issue in isolation, without interference from extraneous factors. Additionally, there does not seem to be a *de minimis*-test in the disadvantage-analysis under Article 24: as soon as the subject of comparison incurs a disadvantage, the domestic measure at issue is liable to constitute discrimination.

Benefits granted under a tax treaty with a third State do not form part of the standard of treatment to which the subject of comparison is entitled under Article 24 OECD MC. Given the reciprocity underlying tax treaties, benefits granted in a tax treaty contribute to the overall balance of that treaty and cannot be separated therefrom. As a result, such benefits cannot be extended to taxpayers not falling within the treaty's scope of application by applying the non-discrimination provision of another tax treaty. Obviously, the situation is different where the discrimination at issue is not caused by a tax treaty with a third State, but by the tax treaty of which Article 24 is invoked. In such a case, it is necessary to interpret the treaty so as to reveal which provision the treaty partners wanted to give precedence over the other.

Unlike the standard developed by the ECJ, Article 24 does not allow contracting States to bring forward arguments of public policy to justify discriminatory taxation. In theory, that could lead national courts to incorporate safety valves in Article 24 by applying the comparability-test or the disadvantage-test in a very liberal way. That is to say, national courts could be tempted to disguise justification arguments as comparability- or disadvantage-arguments in order to uphold discriminatory taxation. However, apart from some marginal examples, there is no real indication in the published case law that there is any such tendency.

Finally, it was observed that there is little interaction between the different paragraphs of Article 24 OECD MC. In the rare instances where two non-discrimination clauses of the same treaty can be applied simultaneously (i.e. if the domestic measure discriminates on the basis of both prohibited criteria at the same time), a strict application of the two clauses separately leads to the result that neither clause has been infringed. However, it has been submitted that the preferable approach in such a case is to apply both clauses at the same time.

B. The standard developed by the ECJ

With respect to the ‘European’ standard, the first conclusion to be drawn from the ECJ’s case law is that the Court has tried to apply a restriction-based reading of the freedoms in direct tax cases, as it has done in other areas. However, given the particular nature of direct taxation (particularly the retained sovereignty of the Member States), that attempt has largely proven unsuccesful. For certain specific procedural matters, a restriction-approach is possible, i.e. where the objective sought by the domestic measure under scrutiny can also be achieved by another Member State’s regime (also taking into account, for instance, the applicable rules on information exchange; see *Futura*). In such a case, the first Member State must refrain from applying its restrictive regime and recognize the effect of the other Member State’s regime. In contrast, issues of substantive direct taxation are not suited for a restriction-approach (see, e.g., *Kerckhaert-Morres*). As a result, most ‘restriction’ cases are based on the same non-discrimination-test as the traditional discrimination cases. The difference between both bodies of case law is the object of comparison: in ‘restriction’ cases, the comparison is no longer made between a national of one Member State exercising his Treaty freedoms and a comparable national of the Member State which (allegedly) discriminates, but rather between a national of a Member State exercising his freedoms and a comparable national of the same Member State who does not exercise those freedoms.

As to the actual application of the non-discrimination standard, the same three steps as under Article 24 can be discerned: (1) is the taxpayer entitled to protection under the fundamental freedoms, (2) is the subject of comparison comparable to the object of comparison and (3) is the subject of comparison treated less favourably as compared to the object of comparison. (4) Yet, there is also a fourth step in the ECJ’s analysis, namely the question whether the discrimination can be justified.

As to the first step, the Court has given a very wide scope of application to the fundamental freedoms. As soon as there is a link with the internal market, that is to say, as soon as the exercise of the free movement provisions may be dissuaded, the Court considers the fundamental freedoms applicable. A striking example is the *Schempp*-case, in which the taxpayer relying on the fundamental freedoms had not exercised those freedoms, but his former spouse had. The Court considered that the free movement provisions could be applied because the fact that the former spouse had exercised her right to move and reside freely in another Member State influenced Mr Schempp's capacity to deduct the maintenance payment from his taxable income in Germany.

The second step, the comparability-analysis, is essentially concerned with identifying the relevant characteristic and then considering whether that characteristic is shared by the subject and object of comparison. The question which characteristic is relevant depends on (the purpose of) the measure under scrutiny. For instance, the relevant characteristic for a domestic measure that grants tax benefits in order to take account of a taxpayer's personal or family situation is the taxpayer's ability to pay tax, since the purpose of such a measure is to match a taxpayer's tax burden to his ability to pay. As discussed earlier, there is no perfect indicator for ability to pay tax, but the least imperfect indicator is arguably the amount of income earned by that taxpayer. Consequently, where a Member State grants its residents a personal benefit, proportionately corresponding to the amount of income earned in that State, it should extend that benefit on a pro rata basis to non-residents, depending on the amount of income earned there. On the other hand, certain other measures are not concerned with ability to pay but try to achieve a different purpose. For instance, certain domestic measures try to remove double taxation on dividends. From the perspective of such measures, the relevant characteristic is the susceptibility to double taxation (irrespective of whether it concerns domestic, inbound or outbound dividends). Similarly, domestic measures that are linked to a specific type of income or activity (e.g. domestic rules on the deductibility of business expenses) have little to do with a taxpayer's ability to pay tax. Instead, the relevant characteristic from the perspective of such measures is the fact that a taxpayer earns that type of income in the Member State concerned or carries out that activity there (which is reflected in the Member State in question exercising its taxing jurisdiction as regards the relevant income or activity).

A particularly difficult issue is the influence of tax treaties on the ECJ's discrimination-analysis. Where an advantage is granted under a tax treaty to one category of non-residents but not to another category of non-residents, the Court's general approach seems to be to verify whether the tax treaty provision at issue is a benefit separable from the remainder of the treaty or, conversely, whether it is an integral part thereof and contributes to its overall balance. In the latter case, the different categories of non-residents are not comparable, which means that the disadvantage is not discriminatory. In the former case, the situations are comparable, which means that the other steps of the discrimination-analysis have to be applied. That approach may be questionable, since horizontal discrimination is equally detrimental to the internal market as vertical discrimination. So there is no reason to treat both types of discrimination differently. Consequently, it could be argued that the Member State in question is required to unilaterally extend the benefits granted in a tax treaty to all EU citizens. Such an extension would not affect the balance and reciprocity of the tax treaty and would remove the horizontal discrimination. Nevertheless, an exception must be made with respect to tax treaty provisions that allocate taxing powers between Member States. Given Member States' retained sovereignty in direct tax matters, such allocation rules do not come within the scope of the fundamental freedoms.

The disadvantage-test is generally not dealt with in detail in the ECJ's analysis, but its importance should not be understated. First of all, the Court does not accept a *de minimis*-exception: as soon as the subject of comparison incurs a disadvantage, the measure at issue may constitute discrimination. Furthermore, the Court generally refuses to take account of unilateral counterbalancing advantages that may remove the disadvantage. On the other hand, there are indications that bilateral measures may offset the disadvantage, but this is subject to very strict conditions (to be assessed by the referring court).

The fourth step in the Court's analysis was not dealt with extensively in this study because it does not concern the existence of discrimination but the justification thereof. The main point that was addressed in that context was the difficulty of distinguishing between justification grounds and elements determining the comparability of the subject and object of comparison. Since justification grounds relate differently to the subject and object of comparison, they can generally be rephrased in terms of comparability. Conversely, elements of the comparability-analysis can also be rephrased in terms of justification (i.e. by arguing that the reason for incomparability justifies the discrimination). However, there is a fundamental difference between these concepts, namely that justification grounds are inherent in the comparative attribute. As a result, they cannot be relied on in the comparability-analysis, since elements that are inherent in the comparative attribute should be disregarded in that context. Yet, these arguments reflect valid policy concerns which Member States are allowed to safeguard. For that reason, they may justify discriminatory taxation.

Finally, it was discussed whether the ECJ's traditional discrimination-analysis could be improved by drawing inspiration from the internal consistency test, as developed by the U.S. Supreme Court. Instead of constructing a comparable internal situation, ICT considers what would happen if all States applied the regime under scrutiny. If the disadvantage would disappear, the measure is internally consistent, which means that possible disadvantages are due to the interplay of different tax systems. In that respect, the conclusion was that, even though ICT may simplify the factual analysis in a number of situations, its weaknesses ultimately outweigh its strengths. As a result, it was concluded that the better approach would be to apply the traditional discrimination-analysis in a consistent and theoretically correct manner. Doing so would produce clearer and more coherent case law, and would effectively allow the Court to distinguish between discrimination and disparities.

2. Identifying a common principle

As to the second objective of this study, the comparison of the two standards has revealed that there is indeed a common core concept that underlies both Article 24 OECD MC and the ECJ's case law.

That core concept of non-discrimination consists of a common analytical framework. Both standards can be seen as expressions of the framework set out in Part I, B.II. That is to say, both standards first consider whether the subject and object of comparison are comparable and then determine whether the subject of comparison incurs a disadvantage as compared to the object of comparison. As to the first step, both standards construct the comparison by considering all relevant characteristics and then determine whether those characteristics are shared by the subject and object of comparison (unless those characteristics are inherent in the comparative attribute). As to the second step, both standards reject the possibility of counterbalancing advantages and the possibility of a *de minimis*-exception.

Additionally, the finality of the two standards is quite similar. Both standards start from the assumption that discriminatory tax measures form an obstacle to cross-border trade. By striking down such discriminatory measures, the standards seek to ensure that reciprocal trade can take place in optimal conditions. Ultimately, the main difference between both standards is that tax treaties are bilateral in nature, while the European standard forms part of a legal fabric encompassing an entire internal market. But this distinction is not as absolute as it may seem, since the OECD plainly aspires to create a worldwide network of identical tax treaties, all based on the OECD MC and interpreted according to the OECD Commentary.

As to the content of the standards, the main difference is that the scope of application of the 'European' standard has gradually expanded to cover all types of tax discrimination that are detrimental to the realization of an internal market. In order to keep that continuous expansion in check, the Court has accepted a number of rule of reason-justifications which, in the context of direct taxation, take account of the Member States' legitimate interest in maintaining their sovereignty. In contrast, the applicability of the non-discrimination standard of Article 24 OECD MC has remained confined to the specific situations set out in the different paragraphs of the provisions. Given that strict scope of application, there has been no need for an open justification-standard. The only justification grounds are those expressly mentioned in the OECD MC or in the Commentary.

3. The influence of the ECJ's standard on the interpretation of Article 24

Given the similarity of both standards, and the perception that the 'European' standard outperforms the 'international' standard, there is a possibility that national courts draw inspiration from the ECJ's case law when they apply Article 24, which could lead to increased protection for taxpayers challenging discriminatory tax measures. However, the reported case law does not reveal widespread influence. Article 24 seems to be interpreted identically by national courts of EU Member States and national courts of non-Member States. The only deviation is that national courts of EU Member States decide more often in favour of the taxpayer where a tax treaty with a non-Member State is concerned. However, it is unlikely that that deviation reveals a desire to offer broader protection to taxpayers in that context. Rather, it seems that EU Member States have removed tax discrimination to a significant extent, but only in relation to other Member States. Additionally, it seems likely that taxpayers are inclined to rely on the fundamental freedoms where possible (i.e. where two Member States are involved) and only on Article 24 where that is impossible (i.e. where a non-Member State is involved, barring the possible application of the free movement of capital).

Nevertheless, the past decade has seen a number of cases in which this influence was expressly articulated, so it is possible that the influence will gradually increase in the future. Unfortunately, the national courts that draw inspiration from the ECJ's case law do not indicate why such an influence is necessary or appropriate. In this context, it was submitted that European law does not require Article 24 to be interpreted in accordance with the ECJ's case law. As a result, the principle of legal certainty requires Article 24 to be interpreted uniformly by all national courts, without any influence from specific legal instruments aimed at regional market integration.